

# Report Highlights

## Teachers' Retirement System of Louisiana

April 2005

### Louisiana Legislative Auditor

**Steve J. Theriot,**  
CPA  
**Legislative Auditor**



The Teachers' Retirement System of Louisiana (TRSL) is a retirement plan created by state law to provide retirement benefits for Louisiana classroom teachers. However, membership was expanded to include school food services employees. As of June 30, 2004, TRSL's membership consisted of 159,434 members, of which 52,900 were retired. TRSL's purpose is to provide benefits to members and their dependents at retirement.

As directed by Senate Concurrent Resolution Number 14 of the 2004 Regular Session, we examined various aspects of TRSL's investment activities, including the system's asset allocation policy, investment return data, investment manager fees, selection and monitoring of investment advisors, and corrective actions for underperforming investment advisors.

## Audit Results

- TRSL's long-term total investment returns have exceeded the system's actuarially assumed rate of return of 8.25%. The system achieved a 9.59% annualized return over the past 10 fiscal years and 9.62% since inception of computing returns (1989). Eleven of TRSL's 14 asset classes have performed above their respective comparable benchmark indices, long-term. However, most of these class returns are not adjusted for investment management fees.
- TRSL has implemented an investment policy that allocates system assets by balancing risks with returns on investment. However, TRSL's investment policy does not address how or when rebalancing (of the system's asset allocation) should be conducted and does not require that the use of index funds be regularly and formally evaluated. Otherwise, the policy minimizes risk of loss.
- TRSL monitors compliance with the asset allocation set forth in the system's investment policy and adopted by the system's investment committee and board of trustees. However, we found that as of June 30, 2004, three asset classes were outside of their asset allocation target ranges.
- The majority of fees TRSL is paying to money managers of traditional assets are lower than the median fees obtained from one fee survey conducted by Independent Consultants Cooperative (ICC). However, about half of the fees TRSL pays these same money managers are above the average obtained from another fee survey conducted by Greenwich Associates of Greenwich, Connecticut (Greenwich).
- TRSL's consultant fees were higher than the Greenwich survey average.
- TRSL does not adequately monitor investment managers' use of affiliated brokers. TRSL has properly monitored its consultants but should improve monitoring its custodian bank.
- TRSL has invested almost \$2.26 billion (19.3% of its portfolio) in alternative investments (private equity, real estate, and mezzanine debt) as of June 30, 2004. TRSL's approximate rates of return, net of fees, for a five-year period ending on June 30, 2004, were 2.0% for domestic private equity, 7.5% for international private equity, 8.2% for real estate, and 13.1% for mezzanine debt.
- TRSL's policies and procedures may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found instances where gifts were accepted by TRSL's staff and consultant from investment managers, a possible violation of the Louisiana Code of Governmental Ethics. In addition, TRSL's trustees, staff, and consultant accepted meals from its investment managers, consultants, and custodian.

## How Do the Investment Returns for Different Asset Classes of TRSL Compare to Relevant Benchmarks?

- TRSL's investment returns have exceeded the system's actuarially assumed rate of return of 8.25% by an annualized 1.34 percentage points over 10 years.
- Eleven of TRSL's 14 asset classes have performed above their respective comparable benchmark indices, long-term. However, most of these asset class returns are not adjusted for investment management fees (i.e., they are presented gross fees).

### RECOMMENDATIONS

- ✓ TRSL should ensure that when asset manager investment returns are compared to benchmarks in investment performance reports, they are presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.
- ✓ TRSL should work to develop appropriate benchmarks for each of its alternative investment asset classes so that their long-term performance can be objectively evaluated.



## Has TRSL Developed and Implemented an Investment Policy That Allocates System Assets by Balancing Risks With Returns on Investments and Ensures That Investments are of Sufficient Quality to Minimize the Risk of Loss of System Assets?

- TRSL has implemented an investment policy that allocates system assets by balancing risks with returns on investment.
- TRSL's investment policy does not address how or when rebalancing should be conducted. In addition, TRSL's investment policy does not require that the use of index funds be regularly and formally evaluated. Otherwise, TRSL's investment policy ensures that investments are of sufficient quality to minimize the risk of loss.

- TRSL has procedures to provide for its short-term cash needs.

### RECOMMENDATION

- ✓ TRSL's written investment policy should ensure that the use of index funds as an alternative active management is "formally and regularly" evaluated.

## Does TRSL Monitor Compliance With the Asset Allocation Component of the System's Established Investment Policy?

- TRSL monitors compliance with the asset allocation set forth in the system's investment policy. However, TRSL's investment policy does not specifically provide when or how TRSL should rebalance its assets.
- Three of TRSL's asset classes (domestic investment-grade fixed-income, mezzanine debt, and private equity) were outside their target ranges as of June 30, 2004.

### RECOMMENDATIONS

- ✓ TRSL should develop and implement specific, written policies concerning rebalancing. These policies should state who will be responsible for rebalancing and provide guidelines for how and when rebalancing will be carried out.
- ✓ If the amounts in asset classes are still outside of their target ranges, TRSL should take immediate steps to rebalance its portfolio so that it is in compliance with its asset allocation policy or change the target ranges in its policy. TRSL should consider the illiquidity of the alternative investment asset classes when setting target ranges. These asset classes may need wider ranges within which to operate than the more liquid asset classes.

## How Do TRSL Money Manager, Consultant, and Custodial Fees and Charges Compare to Other Pension Plans?

- The vast majority of fees TRSL is paying to money managers of traditional assets are lower than the median fees obtained from one fee survey (ICC). However, about half of the fees TRSL pays these same money managers are above the average obtained from another fee survey (Greenwich).

- TRSL's consultant fees were higher than the Greenwich survey average. According to TRSL's chief investment officer, this condition is due to the system's large allocation to the alternative investments asset class.
- The annual fees TRSL pays to its custodian are lower than averages we obtained from the Greenwich survey.

### **Does TRSL Use Competitive, Objective Procedures With Performance Based Criteria to Select Investment Managers, Investment Consultants, and Custodian?**

- TRSL's selection policies and procedures for its custodian, consultants, and public portfolio investment managers are in line with most of the industry standard criteria recommended by the Government Finance Officers Association (GFOA). However, we could not locate some search-related documents; TRSL selected one manager without conducting onsite due diligence; and TRSL does not have written duties and responsibilities for its custodian and consultants in a single policy document.
- TRSL's current policies and procedures for selecting alternative investment managers have improved from those used in guiding the selection of TRSL's alternative investment managers before August 2001.



#### **RECOMMENDATIONS**

- ✓ TRSL should better organize and keep all documents related to its due diligence activities during search/selection processes.
- ✓ TRSL should adopt written, general descriptions of duties and responsibilities for its custodian and each of its three consultants. These duties and responsibilities should be placed in the board's policies.

### **Does TRSL Use Objective Procedures With Performance Based Criteria to Monitor Investment Managers (Including Investment Performance and Churning), Investment Consultants, and Custodian?**

- TRSL uses objective procedures and has properly monitored its investment managers. However, TRSL does not adequately monitor investment managers' use of affiliated brokers.
- TRSL has properly monitored its consultants but should improve monitoring its custodian bank. TRSL also does not have any written policies concerning the formal annual review of its consultants' and custodian's performance.
- TRSL does monitor whether its investment managers are churning the assets held in their accounts. However, TRSL has no written policies in place for the prevention of churning.

#### **RECOMMENDATIONS**

- ✓ TRSL should include a prohibition against using affiliated brokers in its investment manager contracts and review trading activity once a manager is hired to ensure that affiliated brokers are not used.
- ✓ TRSL should formalize its current practices for monitoring investment managers for the churning of TRSL assets into its written policies.
- ✓ TRSL should formalize its current practices for evaluating its consultants into its written policies.
- ✓ TRSL should develop and implement written policies and procedures for formal custodial review (at least annually). These policies and procedures should state the frequency of evaluations and the areas to be evaluated.

### **If Performance by Investment Managers, Investment Consultants, or Custodian Is Below Relevant Benchmarks, Does TRSL Take Corrective Action?**

- TRSL takes corrective action for poorly performing money managers and for the system's custodian.
- TRSL has not had to take corrective action against any of its three consultants, one of which has been TRSL's consultant since 1990.

- ➡ TRSL has few policies relating to corrective action for underperforming managers, consultants, and custodians.

### RECOMMENDATION

- ✓ TRSL should formalize its current practices related to corrective action against investment managers into its written policies.



### What Role Do Alternative Investments Play in TRSL's Investment Portfolio?

- ➡ TRSL has alternative investments in private equity, real estate, and mezzanine debt totaling almost \$2.26 billion, as of June 30, 2004, which constituted 19.3% of TRSL's investment portfolio.
- ➡ Alternative investments have historically produced above-average returns and they provide portfolio diversification. The disadvantages of alternative investments include their high management fees, the risks associated with these investments, and the concern that their reported rates of returns may not be accurate and reliable.
- ➡ The percentage of TRSL's portfolio allocated to alternative investments is significantly higher than an average of public retirement systems in the U.S. TRSL's percentage of alternative investments is also higher than five other state systems comparable in asset size to TRSL.

### Does TRSL Employ Adequate Policies and Procedures to Ensure That Primary Decision Makers Avoid Conflicts of Interest as Well as the Appearance of Conflicts of Interests?

- ➡ TRSL's staff and consultant may have violated the Louisiana Code of Governmental Ethics by accepting gifts from investment managers hired by TRSL. From July 1, 2003, through October 15, 2004, TRSL's staff received Christmas baskets totaling \$160.
- ➡ Trustees and staff received travel reimbursements in the amount of \$6,159 provided by some of the alternative investment managers. In addition, investment managers gave \$1,100 to charities on behalf of TRSL's trustees and staff. It is not clear whether these constitute a violation of the ethics code.
- ➡ From July 1, 2003, through October 15, 2004, TRSL's trustees, staff, and consultant accepted meals from investment managers, consultants, and custodian valued at \$51,598. These meals do not violate the Code of Ethics; however, they represent a potential conflict of interest for trustees and staff.
- ➡ TRSL has a "blackout period" policy in which a potential manager may not discuss an RFP with any trustee outside of board meetings. However, we found two violations of the blackout period policy with what seems to be no negative recourse for one of the managers in violation, as they were later hired.

### RECOMMENDATIONS

- ✓ TRSL should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of these gifts, travel reimbursements, and charitable donations constitute a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, TRSL should strengthen policies and procedures to ensure that all staff and trustees adhere to the Louisiana Code of Governmental Ethics. TRSL should clearly communicate the applicability of the ethics code to TRSL's trustees and staff and the provisions of the code to all investment managers.
- ✓ TRSL should strengthen policies and procedures to ensure that all trustees and staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers.

- ✓ TRSL should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.
- ✓ TRSL should strengthen its blackout period procedures to prohibit all contact between potential contractors and the trustees outside of board and committee meetings during the entire selection process regardless of prior relationships between the system and the contractors in question.
- ✓ TRSL should add its blackout period provisions to the TRSL Board Governance policies to ensure that no violations occur and make all relevant parties aware of the policy.
- ✓ TRSL should develop and implement written policies to ensure that investment managers disclose and avoid any potential conflicts of interest.
- ✓ TRSL should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest between consultants and current and prospective investment managers and custodians.

## Louisiana Legislative Auditor

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**Questions?  
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# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA



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PERFORMANCE AUDIT  
ISSUED APRIL 20, 2005

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April 20, 2005

The Honorable Donald E. Hines,  
President of the Senate  
The Honorable Joe R. Salter,  
Speaker of the House of Representatives

Dear Senator Hines and Representative Salter:

This report gives the results of our performance audit of the Teachers' Retirement System of Louisiana. The audit was conducted under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. Senate Concurrent Resolution Number 14 of the 2004 Regular Session directed our office to examine each of the four state retirement systems.

The report contains our findings, conclusions, and recommendations. Appendix D contains the agency's response. I hope this report will benefit you in your legislative decision-making process.

Sincerely,

Steve J. Theriot, CPA  
Legislative Auditor

SJT/ss

[TRSL05]



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## EXECUTIVE SUMMARY

Article X, Section 29 of the Louisiana Constitution of 1974 provides that the legislature shall provide for retirement of teachers, other employees of the public educational system and state employees, and this is to be done by establishment of one or more retirement systems. This performance audit primarily examines two areas of the Teachers' Retirement System of Louisiana--investments and ethics. Our findings are summarized as follows:

### Performance Audit Findings

#### Investments *(See pages 13 through 47 of the report.)*

##### **How Do the Investment Returns for Different Asset Classes of Teachers' Retirement System of Louisiana (TRSL) Compare to Relevant Benchmarks?**

TRSL's long-term total investment returns have exceeded the system's actuarially assumed rate of return of 8.25%. The system achieved a 9.59% annualized return over the past 10 fiscal years and 9.62% since inception of computing returns (1989). Eleven of TRSL's 14 asset classes have performed above their respective comparable benchmark indices, long-term. However, most of these asset class returns are not adjusted for investment management fees (i.e., they are presented gross of fees). *See pages 13-16.*

##### **Has TRSL Developed and Implemented an Investment Policy That Allocates System Assets by Balancing Risks With Returns on Investments and Ensures That Investments Are of Sufficient Quality to Minimize the Risk of Loss of System Assets? Does TRSL Monitor Compliance With the Asset Allocation Component of the System's Established Investment Policy?**

TRSL has implemented an investment policy that allocates system assets by balancing risks with returns on investment. However, TRSL's investment policy does not address how or when rebalancing (of the system's asset allocation) should be conducted and does not require that the use of index funds be regularly and formally evaluated. Otherwise, the policy minimizes the risk of loss. *See pages 17-20.*

TRSL monitors compliance with the asset allocation set forth in the system's investment policy and adopted by the system's investment committee and board of trustees. However, we found that as of June 30, 2004, three asset classes were outside of their asset allocation target ranges. *See pages 21-24.*

##### **How Do TRSL's Money Manager, Consultant, and Custodial Fees and Charges Compare to Other Pension Plans?**

The vast majority of fees TRSL is paying to money managers of traditional assets are lower than the median fees obtained from one fee survey. However, about half of the fees TRSL pays these same money managers are above the averages obtained from another fee survey. These two surveys were prepared by the Independent Consultants Cooperative and Greenwich Associates of Greenwich, Connecticut (Greenwich). *See pages 25-29.*

TRSL's consultant fees were higher than the Greenwich average. According to TRSL's chief investment officer, this situation is due to the system's large allocation to the alternative investments asset class. The annual fees TRSL pays to its custodian are lower than averages we obtained from the Greenwich survey. *See page 29.*

##### **Does TRSL Use Competitive, Objective Procedures With Performance Based Criteria to Select Investment Managers, Investment Consultants, and Custodian?**

Although TRSL uses competitive, objective procedures with performance based criteria to select its custodian, consultants, and public portfolio investment managers, its policies and procedures could be improved. *See pages 31-32.*

TRSL's current policies and procedures for selecting alternative investment managers have improved from those used in guiding the selection of TRSL's alternative investment managers before August 2001. *See pages 32-33.*

### **Does TRSL Use Objective Procedures With Performance Based Criteria to Monitor Investment Managers (Including Investment Performance and Churning), Investment Consultants, and Custodian?**

TRSL uses objective procedures and has properly monitored its investment managers. TRSL does monitor whether investment managers are churning the assets held in their accounts, although TRSL does not monitor investment managers' use of affiliated brokers. In addition, TRSL has properly monitored its consultants but should improve monitoring its custodian bank. TRSL does not have written policies in place for the prevention of churning and the formal annual review of the consultants' and custodian's performance. *See pages 35-38.*

### **If Performance by Investment Managers, Investment Consultants, or Custodian Is Below Relevant Benchmarks, Does TRSL Take Corrective Action?**

TRSL takes corrective action for poorly performing money managers and for the system's custodian. TRSL has not had to take corrective action against any of its three consultants, one of which has been TRSL's consultant since 1990. We found TRSL has few policies relating to corrective action for underperforming managers, consultants, or custodians. *See pages 39-40.*

### **What Role Do Alternative Investments Play in TRSL's Investment Portfolio?**

TRSL has invested almost \$2.26 billion (19.3% of its portfolio) in alternative investments (private equity, real estate and mezzanine debt) as of June 30, 2004. The percentage of TRSL's portfolio allocated to alternative investments is significantly higher than the average of public retirement systems in the U.S. *See pages 41 and 46-47.*

Compared to traditional, public portfolios, alternative investments have higher risks but also have the potential to earn higher rates of return. TRSL's approximate rates of return, net of fees, for a five-year period ending on June 30, 2004, were 2.0% for domestic private equity, 7.5% for international private equity, 8.2% for real estate, and 13.1% for mezzanine debt. *See pages 42-45.*

### **Ethics (See pages 49 through 54 of the report.)**

### **Does TRSL Employ Adequate Policies and Procedures to Ensure That Primary Decision Makers (Board Members, Key System Staff, Money Managers, Custodian, and Consultants) Avoid Conflicts of Interest as Well as the Appearance of Conflicts of Interest?**

The policies and procedures of TRSL may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found instances where gifts were accepted by TRSL's staff and consultant from investment managers, a possible violation of the Louisiana Code of Governmental Ethics. In addition, TRSL's trustees, staff, and consultant accepted meals from its investment managers, consultants, and custodian. *See pages 49-53.*

TRSL does employ some procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. However, TRSL has not developed written policies for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest by investment managers and consultants. *See pages 53-54.*



## AUDIT INITIATION AND BACKGROUND

### Audit Initiation and Objectives

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. Louisiana Revised Statute 24:522 requires, in part, that the legislative auditor establish a schedule of performance audits to ensure that at least one performance audit is completed and published for each executive department within a seven-year period beginning with fiscal year 1998. In accordance with this requirement, the Office of Legislative Auditor developed a plan scheduling a performance audit of the four state retirement systems:

- Teachers' Retirement System of Louisiana (TRSL)
- Louisiana State Employees' Retirement System
- Louisiana School Employees' Retirement System
- State Police Pension and Retirement System

The Legislative Audit Advisory Council approved this audit on March 5, 2004. In addition, Senate Concurrent Resolution Number 14 of the 2004 Regular Session directed our office to examine the four state retirement systems. The resolution specified that we focus on "the relationships between the state public retirement systems' boards and the investment advisors, consultants and managers." Appendix A contains our audit scope and methodology.

The objectives of this audit are:

- How do the investment returns for different asset classes of TRSL compare to relevant benchmarks?
- Has TRSL developed and implemented an investment policy that allocates system assets by balancing risks with returns on investments and ensures that investments are of sufficient quality to minimize the risk of loss of system assets?
- Does TRSL monitor compliance with the asset allocation component of the system's established investment policy?
- How do TRSL's money manager, consultant, and custodial fees and charges compare to other pension plans?
- Does TRSL use competitive, objective procedures with performance based criteria to select investment managers, investment consultants, and custodian?
- Does TRSL use objective procedures with performance based criteria to monitor investment managers (including investment performance and churning), investment consultants, and custodian?

- If performance by investment managers, investment consultants, or custodian is below relevant benchmarks, does TRSL take corrective action?
- What role do alternative investments play in TRSL's investment portfolio?
- Does TRSL employ adequate processes and procedures to ensure that primary decision makers (board members, key system staff, money managers, custodian, and consultants) avoid conflicts of interest as well as the appearance of conflicts of interest?

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### Overview of TRSL

**Purpose and Statutory Authority:** Article X, Section 29 of the Louisiana Constitution of 1974 provides that the legislature shall provide for retirement of teachers, other employees of the public educational system and state employees, and this is to be done by establishment of one or more retirement systems. There are four state systems:

- Teachers' Retirement System of Louisiana (TRSL)
- Louisiana State Employees' Retirement System
- Louisiana School Employees' Retirement System
- State Police Pension and Retirement System

The Louisiana Legislature established TRSL in 1936 by Act No. 83. TRSL is a defined benefit pension plan initially created to provide retirement benefits for Louisiana classroom teachers. However, membership was expanded to include school food services employees. The purpose of TRSL is to provide benefits to members and their dependents at retirement or in the event of death, disability or termination of employment.

**Background Information:** A retirement system's financial health is primarily measured by its funded ratio, which is the extent to which a system's assets are sufficient to pay for present and future liabilities. As of June 30, 2003, TRSL's funded ratio was 68.8%, and it decreased to 63.1%, as of June 30, 2004. Another measure of a system's financial health is the amount of its unfunded accrued liability (UAL). UAL is defined as that portion of the actuarially calculated liability not funded by the actuarial value of the system assets. TRSL's UAL was \$5.4 billion and \$6.7 billion, as of June 30, 2003 and 2004, respectively. If a system achieves a long-term rate of return on its investments greater than the assumed actuarial rate (of 8.25%), the system's funding status will improve, assuming all other factors remain equal. Exhibits 1 and 2 on the following pages provide background information concerning TRSL's finances, budget, and funding.

Exhibit 1 TRSL Statistics as of June 30, 2003 and 2004					
As of June 30	Fiscal Year Net Investment Income	Net Assets	Unfunded Actuarial Accrued Liability	Percentage Funded	Fiscal Year Administrative Expenses
2003	\$221 million	\$10.5 billion	\$5.4 billion	68.8%	\$10,688,003
2004	\$1.7 billion	\$11.9 billion	\$6.7 billion	63.1%	\$10,786,450
<b>Source:</b> Prepared by legislative auditor's staff using TRSL's audited financial statements for fiscal years 2003 and 2004.					

As shown in Exhibit 2, TRSL's primary source of funding in fiscal year 2004 was investment income of approximately \$1.8 billion. Funding sources in addition to investment income include the following:

- Employer contributions
- Member contributions
- Other income

Exhibit 2 details the system's budgeted uses of funds for fiscal year 2005 and actual sources and uses of funds in fiscal year 2004. TRSL does not budget for investment income and other sources of funds. Exhibit 2 also contains a variance calculation for these two years.

# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

## Exhibit 2 Sources and Uses of Funds Comparison of Fiscal Years 2004 and 2005

	FY 2005 Proposed Budget	FY 2004 Actual	Difference Between 2004 and 2005	Percentage Change From 2004 to 2005
Investment Income	n/a <sup>1</sup>	\$1,811,890,660	n/a <sup>1</sup>	n/a <sup>1</sup>
Member Contributions	n/a <sup>1</sup>	\$264,999,131	n/a <sup>1</sup>	n/a <sup>1</sup>
Employer Contributions	n/a <sup>1</sup>	\$444,104,350	n/a <sup>1</sup>	n/a <sup>1</sup>
Other Income and Contributions	n/a <sup>1</sup>	\$52,316,706	n/a <sup>1</sup>	n/a <sup>1</sup>
<b>Total Funding Sources</b>	n/a <sup>1</sup>	\$2,573,310,847	n/a <sup>1</sup>	n/a <sup>1</sup>
Retirement Benefits Paid	n/a <sup>1</sup>	\$1,075,298,667	n/a <sup>1</sup>	n/a <sup>1</sup>
Refund of Contributions	n/a <sup>1</sup>	\$26,804,821	n/a <sup>1</sup>	n/a <sup>1</sup>
Salaries	\$7,285,676	\$6,175,649	\$1,110,027	18%
Salaries - Related Benefits	\$1,859,876	\$1,489,156	\$370,720	25%
Travel	\$306,850	\$197,581	\$109,269	55%
Operating Services	\$3,179,777	\$2,160,876	\$1,018,901	47%
Supplies	\$192,886	\$165,765	\$27,121	16%
Accounting & Auditing	\$45,600	\$32,600	\$13,000	40%
Management & Consulting	\$100,000	\$191,346	(\$91,346)	-48%
Actuarial	\$105,000	\$95,804	\$9,196	10%
Legal	\$204,000	\$50,336	\$153,888	306%
Medical	\$30,000	\$20,153	\$9,847	49%
Professional Travel	\$2,500	\$2,246	\$254	11%
Design/Annual Report	\$2,000	\$0	\$2,000	n/a
Other Professional Services	\$297,600	\$160,681	\$136,918	85%
Acquisitions	\$273,114	\$423,070	(\$149,956)	-35%
Other Charges	\$26,200	\$22,320	\$3,880	17%
Interagency Transfers	\$60,984	\$31,296	\$29,688	95%
International Investment Expense	n/a <sup>1</sup>	\$4,995,570	n/a <sup>1</sup>	n/a <sup>1</sup>
Alternative Investment Expense	n/a <sup>1</sup>	\$49,401,029	n/a <sup>1</sup>	n/a <sup>1</sup>
Custodian Fees	\$750,000	\$786,062	(\$36,062)	-5%
Performance Consultant Fees*	\$689,000	\$547,749	\$141,251	26%
Advisor Fees	\$21,178,434	\$23,311,668	(\$2,133,234)	-9%
Securities Lending Expense	n/a <sup>1</sup>	\$8,151,150	n/a <sup>1</sup>	n/a <sup>1</sup>
Administrative Expenditures Included in Operating Budget but Not in Financial Statements	n/a <sup>1</sup>	(\$432,429)	n/a <sup>1</sup>	n/a <sup>1</sup>
Depreciation Expense	n/a <sup>1</sup>	\$508,399	n/a <sup>1</sup>	n/a <sup>1</sup>
<b>Total Fund Uses</b>	n/a <sup>1</sup>	\$1,200,591,567	n/a <sup>1</sup>	n/a <sup>1</sup>
<b>Net Funding Sources</b>	n/a <sup>1</sup>	\$1,372,719,280	n/a <sup>1</sup>	n/a <sup>1</sup>

**Notes:** <sup>1</sup>TRSL only budgets for select administrative and investment expenditures.

\*Trade cost analysis fees are included in this amount.

**Source:** Prepared by legislative auditor's staff using TRSL's fiscal year 2004 audited financial statements and board approved operating budget.

TRSL's members are vested after five years of service, meaning that after this time they are eligible for a retirement benefit once a certain age is reached. Most members of TRSL with 30 years of service may retire and draw benefits at any age. Benefits are generally calculated by multiplying the applicable rate (2.5% rate for each year of service) times years of creditable service times the member's average earned compensation for the 36 highest successive months of employment. Exhibit 3 provides information concerning the membership of the TRSL system.

<b>Exhibit 3 TRSL Membership Components Fiscal Years 2002, 2003, and 2004</b>			
<b>Membership Categories</b>	<b>As of June 30, 2002</b>	<b>As of June 30, 2003</b>	<b>As of June 30, 2004</b>
Active Members	87,356	87,646	87,273
Terminated Vested Members	624	5,720	5,610
Terminated Non-Vested Members	10,881	7,852	10,242
Retired Members	49,053	50,903	52,900
DROP Participants	5,103	2,722	3,409
<b>Total Membership</b>	<b>153,017</b>	<b>154,843</b>	<b>159,434</b>
<b>Source:</b> Prepared by legislative auditor's staff using TRSL's audited financial statements from fiscal years 2003 and 2004.			

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## HOW DO THE INVESTMENT RETURNS FOR DIFFERENT ASSET CLASSES OF TRSL COMPARE TO RELEVANT BENCHMARKS?

TRSL's long-term total investment returns have exceeded the system's actuarially assumed rate of return of 8.25%. The system achieved a 9.59% annualized return over the past 10 fiscal years and 9.62% since inception of computing returns (1989). Returns for the total portfolio are reported net of fees (i.e., management fees have been subtracted before computing returns).

Eleven of TRSL's 14 asset classes have performed above their respective comparable benchmark indices, long-term. However, most of these asset class returns are not adjusted for investment management fees (i.e., they are presented gross of fees).

### TRSL's Long-Term Total Investment Returns Have Exceeded the System's Actuarially Assumed Rate of Return

According to TRSL's investment staff, TRSL's investment returns have exceeded the system's actuarially assumed rate of return by an annualized 1.34 percentage points over 10 years and by an annualized 1.37 percentage points since inception of computing returns (1989). These numbers are net of fees, which means that the investment managers' fees have been subtracted when computing the rate of return. The actuarial rate is the rate of return that the system's actuary assumes the system will earn when he/she computes its funding ratio. If a system's investment performance exceeds this actuarial assumed rate, the funding ratio and the system's overall financial health may be improved. A system with investment returns less than this rate worsens its funding ratio, all other factors (such as benefits and contributions) remaining equal. Exhibit 4 shows TRSL's investment returns over different time periods.

Exhibit 4 TRSL Total Investment Returns as of June 30, 2004			
Time Period	TRSL's Investment Return (Net of Fees)	Actuarially Assumed Rate of Return	Excess Return (Net of Fees)
1 Year	18.19%	8.25 %	9.94 %
5 Years	4.22 %	8.25 %	(4.03 %)
10 Years	9.59 %	8.25 %	1.34 %
Since Inception (1989)	9.62 %	8.25 %	1.37 %
<b>Source:</b> Prepared by legislative auditor's staff from information provided by Mellon Bank and TRSL's staff.			

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### **Eleven of TRSL's Fourteen Asset Classes Have Yielded Long-Term Investment Returns Above Their Benchmark Indices**

According to data provided by TRSL's investment staff, since inception, TRSL's investment returns (largely gross of fees) for eleven of 14 asset classes were above relevant benchmark indices, as illustrated in Exhibit 5 on the following page. The "since inception" returns are from the date TRSL started tracking returns for the particular asset class. Thus, returns in the large cap equity asset classes are for 11.5 years, while returns for the domestic investment-grade fixed-income asset class are for less than 3 years.

The positive dollar impact on returns for TRSL is approximately \$425 million. This amount is an estimate of the dollar value of TRSL's performance compared to the benchmark. TRSL's mid cap growth equity, domestic investment-grade fixed-income, and domestic private equity asset classes were below their respective benchmark indices.

For the traditional asset classes, TRSL reports publicly traded asset class investment returns gross of fees, which means that the investment managers' fees have not been subtracted when computing the rate of return. Asset class returns for the alternative investments are reported net of fees. Adjusting each traditional asset class's annualized returns by the current average management fee would require subtracting 0.21% from the returns. It seems logical to conclude that the returns for TRSL's traditional asset classes that exceeded index returns, gross of fees, would still exceed the relevant index returns net of fees, although the size of their outperformance would be narrowed. Similarly, the returns for TRSL's traditional asset classes that underperformed index returns, gross of fees, would still underperform the relevant index returns net of fees but by a slightly wider margin.

We discussed the issue of reporting some returns gross of fees rather than net of fees with TRSL's chief investment officer. He explained that the management fees for these managers are paid from a separate account than that containing the invested assets. Therefore, incorporating the effect of fees on asset class returns would be difficult. He also stated that if a manager beat its benchmark by more than the average fee, this condition would be an indication that the manager beat the benchmark, net of fees. However, investment reports submitted to TRSL's board do not provide users with the effect of fees on returns or even what average fees are. Without this information, board members and other decision makers cannot readily determine whether a given manager is beating its benchmark after fees are taken into account.

TRSL's staff stated that they use the S&P 500 plus 4% as a benchmark for alternative investments (domestic private equity, international private equity, real estate, and mezzanine debt), but there may be a more appropriate index to use. According to the Government Finance Officers Association (GFOA), retirement systems should develop appropriate benchmarks for comparison of returns and risk. Since TRSL has not developed appropriate benchmarks for these asset classes, their performance cannot be readily evaluated.

**Exhibit 5**  
**TRSL Since Inception Investment Returns as of June 30, 2004**  
**(Largely Gross of Fees)**

<b>Asset Class</b>	<b>TRSL “Since Inception” Annualized Return<sup>1</sup></b>	<b>Comparable Index “Since Inception” Annualized Return</b>	<b>TRSL Above or Below Index?</b>	<b>Dollar Impact (\$000)</b>
Large Cap Growth Equity <sup>2</sup>	10.92%	8.49%	2.43% Above	\$32,205
Large Cap Value Equity <sup>2</sup>	18.42 %	12.23 %	6.19 % Above	\$70,368
Mid Cap Growth Equity <sup>2</sup>	3.26 %	8.57 %	5.31 % Below	(\$21,583)
Mid Cap Value Equity <sup>2</sup>	14.66 %	13.48 %	1.18 % Above	\$5,265
Small Cap Growth Equity <sup>2</sup>	13.60 %	6.37 %	7.23 % Above	\$35,754
Small Cap Value Equity <sup>2</sup>	23.97 %	13.89%	10.08% Above	\$47,968
International Equity <sup>2</sup>	23.06 %	4.41 %	18.65% Above	\$203,483
Domestic Investment Grade Fixed Income <sup>2</sup>	3.09 %	5.74 %	2.65 % Below	(\$16,418)
High Yield Fixed Income <sup>2</sup>	8.10 %	4.52 %	3.58 % Above	\$20,216
Global Fixed Income <sup>2</sup>	12.04 %	6.78 %	5.26 % Above	\$48,293
Domestic Private Equity	5.72 %	10.77 %	5.05 % Below	(\$44,608)
International Private Equity	8.13 %	5.12 %	3.01 % Above	\$6,161
Real Estate	15.14 %	11.53	3.61% Above	\$12,071
Mezzanine Debt	22.34 %	11.16	11.18% Above	\$25,630
<b>Total</b>				<b>\$424,805</b>

**Notes:** <sup>1</sup> Large Cap Growth Equity, Large Cap Value Equity, and Small Cap Growth Equity contain 11.5 years of data. Mid Cap Growth Equity has 8.8 years, Mid Cap Value Equity has 9 years, Small Cap Value Equity has 8.7 years, International Equity has 10.8 years, Domestic Investment Grade Fixed-Income has 2.9 years, High Yield Fixed-Income has 6.5 years, Global Fixed Income has 11.4 years, Domestic Private Equity has 7.4 years, International Private Equity has 5.6 years, Real Estate has 7.5 years, and Mezzanine Debt has 7.6 years of data.

<sup>2</sup> Returns are gross of fees.

**Source:** Prepared by legislative auditor’s staff using information provided by TRSL’s investment staff.

Benchmark indices are statistical indicators against which investment performance is measured. A typical index is composed of many securities of a similar class, such as securities of companies valued over a certain dollar amount (large capitalization companies) or securities of all international companies. Examples of indices are the S&P 500 and the Russell 2000. The relevant benchmark indices for TRSL’s asset classes are listed and briefly defined in Appendix B.

**Recommendation 1:** TRSL should ensure that when asset manager investment returns are compared to benchmarks in investment performance reports, they are presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.

**Management's Response:** We agree that showing returns net of fees for all investment managers is a useful tool, and we will begin including such in TRSL's monthly reports to the Board of Trustees (see Appendix D for TRSL's full response).

**Recommendation 2:** TRSL should work to develop appropriate benchmarks for each of its alternative investment asset classes so that their long-term performance can be objectively evaluated.

**Management's Response:** We agree that there may exist more appropriate benchmarks for alternative investment subclasses and will work with our alternative investment consultant to explore this possibility (see Appendix D for TRSL's full response).

## **HAS TRSL DEVELOPED AND IMPLEMENTED AN INVESTMENT POLICY THAT ALLOCATES SYSTEM ASSETS BY BALANCING RISKS WITH RETURNS ON INVESTMENTS AND ENSURES THAT INVESTMENTS ARE OF SUFFICIENT QUALITY TO MINIMIZE THE RISK OF LOSS OF SYSTEM ASSETS?**

TRSL has implemented an investment policy that allocates system assets by balancing risks with returns on investment. TRSL's investment policy conforms with seven of the nine criteria that we developed. However, TRSL's investment policy does not address how or when rebalancing should be conducted. In addition, TRSL's investment policy does not require that the use of index funds be regularly and formally evaluated. Otherwise, TRSL's investment policy ensures that investments are of sufficient quality to minimize the risk of loss. TRSL also has procedures to provide for its short-term cash needs.

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### **TRSL Has Developed and Implemented an Investment Policy That Balances Risks With Returns and Minimizes Risk of Loss**

We evaluated TRSL's asset allocation based on a list of nine criteria that a system's investment and asset allocation policies should contain. TRSL's investment policy satisfied seven of nine criteria. In practice, TRSL's current asset allocation procedures appropriately balance investment risks with returns and ensure that investments are of sufficient quality to minimize the risk of loss. These criteria, if adhered to, should mitigate investment risks while maximizing returns. They are listed in Exhibit 6 on page 19. Asset allocation is the single largest determinant of investment returns according to the GFOA. Allocation accounts for 94% of the variation in returns.

One criterion that TRSL did not meet requires the system's investment policy to address how or when rebalancing should be conducted. Related to this criterion, we also found that the amounts in three asset classes were outside of their asset allocation target ranges, as of June 30, 2004. This deviation is discussed in more detail on page 22. The second criterion that TRSL's investment policy did not meet requires the investment policy to ensure that the use of index funds is formally and regularly evaluated as an alternative to active management of investments. We observed instances of indexing being discussed in TRSL's investment committee meetings. However, the system's investment policy does not require it. TRSL's policies and procedures with respect to each of the nine criteria are discussed as follows.

**Low correlation among asset classes:** TRSL's portfolio is divided up among U.S. stocks, international stocks, U.S. and international fixed-income investments, real estate, private equity, and mezzanine debt investments. TRSL's investment policy allocates target percentages of its portfolio to these asset classes. Historically, many of these asset classes have had low correlations with each other. This correlation will help TRSL reduce the risk that its entire portfolio will decrease in value during a given time period.

**Target allocations and ranges for each asset class:** TRSL had an asset-liability study performed in July 2002. Based on this study, TRSL revised some target percentages to allocate its portfolio into various asset classes. These target allocations are included in TRSL's investment policy. Since the value of the portfolio changes daily, the actual portfolio allocation will fluctuate around the target percentages. TRSL has established ranges around these target percentages. Thus, through the use of these target allocations and ranges in its investment policy, TRSL is minimizing its risk for a given level of investment returns.

**Asset allocation tailored with an asset-liability study:** TRSL's consultant prepares asset-liability studies in an attempt to compare the long-term liabilities of the retirement system with expected asset values. TRSL's most recently completed asset-liability study is dated July 2002. The information from this study was used to set the system's most recent asset allocation, which was last changed in September 2002.

**Up to 65% of assets invested in equities:** State law (R.S. 11:267.C) allows TRSL to invest up to 65% of its assets in equities. TRSL's investment policy targets 60% (47% in U.S. equities and 13% in international equities) of its assets to equities, which is within the maximum allowed under state law.

**At least 10% of equity assets invested in index funds:** State law (R.S. 11:267.B) requires TRSL to invest at least 10% of its equity allocation in index funds. As of June 30, 2004, TRSL had 11.2% of its equity portfolio invested in funds that track various indices (such as the S&P 500, S&P 100, and Russell 2000). Therefore, TRSL is mitigating the risk of not tracking a stock market index by investing more than 10% of its equity investments in index funds. TRSL's written investment policy includes a provision that a minimum of 10% of the equity portfolio must be invested in indexed funds.

**Regular rebalancing:** TRSL's investment staff compares the system's actual asset allocation to its target allocation daily, according to staff. Thus, TRSL is systematically reviewing its asset mix to ensure that it takes the least amount of risk to achieve a given level of return. However, we determined that as of June 30, 2004, the TRSL portfolio had three asset classes outside of the target ranges set in the TRSL investment policy. TRSL not rebalancing the assets outside of its target ranges are discussed in more detail on page 22.

**Indexing:** TRSL's officials believe that equity indexed funds, over time, will underperform TRSL's target rate of return of 8.25%. Therefore, TRSL's officials index the minimum amount allowed by law without any formal evaluation of the use of index funds. TRSL does consider the positive and negative aspects of using index funds compared to investment managers. However, this review is not formally required in TRSL's investment policy.

Without a formal evaluation of the use of index funds as an alternative to active management, TRSL does not know in which situations it would be more cost-effective to use indices rather than active management. As an example, if TRSL had invested in the index for the mid-cap growth equity and domestic investment-grade fixed-income, then TRSL would have achieved a higher rate of return as illustrated in Exhibit 5. If the TRSL officials' beliefs are correct for all relevant indices, there would be no effect from not having a policy. If indices are



a cost effective alternative to active management in some situations, however, TRSL's investments may underperform the relevant indices. Regardless of the accuracy of the TRSL officials' beliefs, the regular review of this situation would provide more definitive information about this debate and allow TRSL to determine if any changes in its investment program are warranted.

**Prohibited investments:** TRSL's investment policy lists permissible investments and also specifies eligible investments for alternative investing. Also, the policy contains a list of prohibited investments. In addition, the investment policy provides guidelines for investment managers including maximum percentages in a single issuer or industry and how much a fixed income manager can invest in a single issuer.

<b>Exhibit 6</b> <b>Evaluation of TRSL's Compliance With Criteria for</b> <b>Asset Allocation and Investment Policy</b>	
<b>Criteria</b>	<b>Met by TRSL's Policies?</b>
1. The asset allocation set in the investment policy should contain two or more asset classes (domestic stocks, foreign stocks, domestic bonds, etc.) that have low correlation with one another (i.e., when one is up the other is down) to reduce volatility and therefore risk.	✓
2. Asset allocation ranges should be set that include minimum, maximum, and target allocation percentages for asset classes.	✓
3. The asset allocation of a system should be specifically tailored to the "unique circumstances of the individual system" through an asset-liability study.	✓
4. Investment policies should contain a provision that prohibits and prevents more than 65% of the system's portfolio from being invested in equity securities.	✓
5. To comply with state law, the investment policy should contain a provision that ensures that 10% of the system's portfolio will be invested in index funds.	✓
6. Portfolios should be rebalanced to stay in line with the established asset allocation ranges and to reduce volatility. The portfolio should be reviewed at least annually by the appropriate system official for rebalancing purposes.	X
7. The investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.	X
8. Investment guidelines should identify permissible and non-permissible investments. They should also set maximum percentages of system assets allowed to be invested in a single issuer, asset class, economic sector, and nation.	✓
9. Private equity and real estate investments should be constrained so that the system's portfolio does not become dominated by these non-liquid investments.	✓
<b>Source:</b> Criteria developed by legislative auditor's staff based on the GFOA and the Louisiana Revised Statutes of 1950, as amended.	

**Limits on non-liquid investments:** TRSL's investment policy provides additional guidelines specific to alternative investments (including real estate and private equity) to provide a framework for selecting, building, and managing these investments. The board understands that these investments are illiquid and expects that the system's consultant will take appropriate measures to reduce risks such as diversification, due diligence, and governance activities. The investment policy also limits the commitment size for alternative investments and provides requirements for diversifying the sources of risk in the portfolio. The policy also stipulates that TRSL shall not make any direct investments in any private company or property, but only invest through a commingled partnership, in which TRSL is a limited partner.

Because TRSL has \$2.26 billion (19.3% of its portfolio) invested in alternative investments (as of June 30, 2004), we discuss and explain these types of investments in a subsequent section of our report beginning on page 41.

**Recommendation 3:** TRSL's written investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.

**Management's Response:** We partially agree with the recommendation, in that TRSL already evaluates the use of index funds regularly. Since TRSL evaluates the use of all classes of investments through regular asset allocations studies, we do not believe that singling out, in policy, the review of index funds is warranted. However, we will continue to use index funds as required by law and as appropriate short-term investment vehicles (see Appendix D for TRSL's full response).

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### TRSL Has Procedures to Provide for Its Cash Needs

To meet its cash needs, TRSL holds approximately \$100 million in its short-term investment funds. TRSL's staff estimate the system's cash needs for retiree benefits, refunds, DROP payments, and other operating funds and review their short-term cash balances daily. There are also capital calls from alternative investment managers. The system typically has a one week notice to meet this funding need. These capital calls are tracked by TRSL's staff and additional cash is allocated to satisfy these commitments.

**DOES TRSL MONITOR COMPLIANCE WITH THE ASSET  
ALLOCATION COMPONENT OF THE SYSTEM'S  
ESTABLISHED INVESTMENT POLICY?**

TRSL monitors compliance with the asset allocation set forth in the system's investment policy and adopted by the system's investment committee and board of trustees. However, TRSL's investment policy has no provisions concerning how or when to implement rebalancing. In addition, we reviewed investments by each manager and found that as of June 30, 2004, three asset classes were outside of their asset allocation target ranges.

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**TRSL's Investment Policy Does Not Address Specific  
Aspects of Rebalancing**

TRSL's investment policy does not specifically provide when or how TRSL should rebalance when the amount in an asset class is outside of its target range. The investment policy provides that at least quarterly, the system's asset allocations will be reviewed. In practice, TRSL's investment committee reviews asset allocations monthly, and TRSL's investment staff informed us that they monitor asset allocations daily. When the amount in an asset class goes outside of the target policy range, TRSL's investment policy provides that such divergence should be of a short-term nature and that TRSL's director is responsible for ensuring the divergence is as brief as possible. Exhibit 7 shows the targets and ranges for each asset class. There is a band of varying size on each side of an asset class's target.

Exhibit 7 TRSL's Asset Allocation Policy (Different Asset Classes as a Percentage of the Total Portfolio) (June 30, 2004)			
Asset Class	Minimum	Target	Maximum
1. Domestic Equity (Stock)	40%	47%	55%
2. International Equity (Stock)	10%	13%	15%
<b>Total Equity</b>	<b>50%</b>	<b>60%</b>	<b>65%</b>
3. Domestic Investment-Grade Bonds	9%	10%	20%
4. High Yield Bonds	3%	5%	7%
5. Global Bonds	3%	5%	6%
<b>Total Fixed Income</b>	<b>15%</b>	<b>20%</b>	<b>30%</b>
6. Private Equity*	4%	8%	10%
7. Real Estate	3%	5%	6%
8. Mezzanine Debt	3%	5%	7%
<b>Total Alternative</b>	<b>10%</b>	<b>18%</b>	<b>20%</b>
9. Cash and Equivalents	1%	2%	5%
<b>Total</b>	<b>100 %</b>		
<b>Note:</b> *Private equity includes corporate/finance buyouts and venture capital.			
<b>Source:</b> Prepared by legislative auditor's staff using TRSL's investment policy.			

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### Three Asset Classes Were Outside of Their Target Ranges

Three asset classes were outside of their target ranges, as of June 30, 2004. Domestic investment-grade fixed-income constituted 7.94% of the portfolio, which was 1.06 percentage points below the minimum target of 9%. Mezzanine debt (an alternative investment) constituted 2.58% of the portfolio, which was 0.42 of a percentage point below its minimum target of 3%. Finally, private equity (an alternative investment) constituted 12.25% of the portfolio, which was 2.25 percentage points above its maximum target of 10%. However, the overall allocation percentages for each major asset class (which are bolded in Exhibit 7) were within TRSL's target ranges. Exhibit 8 on page 24 shows the asset classes in TRSL's investment portfolio, the investment managers, and amount of funds invested by each manager. This exhibit also shows whether the asset class was in compliance with TRSL's asset allocation targets. The information contained in Exhibit 8 is as of June 30, 2004.

TRSL provided explanations for these deviations. According to TRSL's CIO, the domestic investment-grade fixed-income allocation has been allowed to stay below the investment policy minimum because of a pending asset allocation study. Under the new asset allocation, no rebalancing of this asset class may be required. Since there are costs associated with rebalancing, TRSL did not want to incur those costs needlessly. The private equity and mezzanine debt investments are illiquid. Assets cannot be added to existing partnerships and new partnerships cannot be formed quickly. In addition, the partnerships TRSL invests in control the flow of cash between TRSL and the partnerships. TRSL makes commitments of a set amount of assets to each partnership. However, a partnership does not receive all of the commitment at once. The partnership makes requests for money (capital calls) and announces distributions of cash to its limited partners (including TRSL). So, TRSL has to anticipate the timing of partnership cash flows. Recently, because of the stock market decline from 2000 to 2003, TRSL's cash flow predictions have not been accurate enough to keep the private equity and mezzanine debt allocations within the target ranges.

Periodically rebalancing a retirement system's portfolio reduces risk and increases investment return and should be considered at least annually according to the GFOA. By not having specific instruction in policy and not ensuring that its asset allocation policy is complied with, even though reviewing it on a regular basis, TRSL is possibly not minimizing its investment risk. The result could be a deviation from the expected portfolio returns and risk levels agreed to by the TRSL board of trustees.

**Recommendation 4:** TRSL should develop and implement specific written policies concerning rebalancing. These policies should state who will be responsible for rebalancing and provide guidelines for how and when rebalancing will be carried out.

**Management's Response:** We partially agree with the recommendation. TRSL will implement a section on rebalancing in the investment policy. However, we will not include specific rebalancing timeframes or requirements, since each rebalancing decision will be based on multiple, complex factors (see Appendix D for TRSL's full response).

**Recommendation 5:** If the amounts in asset classes are still outside of their target ranges, TRSL should take immediate steps to rebalance its portfolio so that it is in compliance with its asset allocation policy or change the target ranges in its policy. TRSL should consider the illiquidity of the alternative investment asset classes when setting target ranges. These asset classes may need wider ranges within which to operate than the more liquid asset classes.

**Management's Response:** We agree, since we have already planned to rebalance due to the asset allocation study that we are presently performing, as previously communicated to your audit staff (see Appendix D for TRSL's full response).

<b>Exhibit 8</b> <b>TRSL's Investment Managers and Amounts Invested</b> <b>(As of June 30, 2004)</b>				
<b>Asset Class</b>	<b>Investment Manager</b>	<b>Amount Invested</b>	<b>Percentage of TRSL's Portfolio</b>	<b>Complies With Target?</b>
Large Cap Growth	Goldman Sachs	\$429,620,335	3.67%	
Large Cap Growth	Smith	\$439,155,778	3.75%	
Large Cap Growth	Atlanta Capital	\$437,616,755	3.74%	
Large Cap Growth	Furman Selz Capital	\$157,159	0.00%	
Large Cap Growth	Rhumblin	\$399,502,803	3.41%	
Large Cap Value	UBS Global	\$330,450,015	2.82%	
Large Cap Value	LSV	\$363,976,080	3.11%	
Large Cap Value	Deutsche	\$316,888,279	2.71%	
Large Cap Value	Bear Stearns	\$219,901,392	1.88%	
Large Cap Value	Rhumblin	\$375,168,104	3.21%	
Mid Cap Growth	Seneca Capital	\$212,223,474	1.81%	
Mid Cap Growth	Forstmann-Leff	\$210,896,727	1.80%	
Mid Cap Growth	Columbus Circle	\$35,123,520	0.30%	
Mid Cap Growth	Eagle Asset	\$67,355,537	0.58%	
Mid Cap Value	Ariel Capital	\$342,982,468	2.93%	
Mid Cap Value	EBS	\$220,016,981	1.88%	
Small Cap Growth	TCW	\$307,664,820	2.63%	
Small Cap Growth	Bank of New York	\$227,997,498	1.95%	
Small Cap Value	Boston Company	\$115,655,100	0.99%	
Small Cap Value	Rothschild	\$228,456,648	1.95%	
Small Cap Value	Systematic Financial	\$222,269,635	1.90%	
<b>Total Domestic Equity</b>		<b>\$5,503,079,108</b>	<b>47.04%</b>	<b>Yes</b>
International Equity	Artisan Partners	\$468,250,776	4.00%	
International Equity	TT International	\$362,734,795	3.10%	
International Equity	New Star	\$579,195,564	4.95%	
<b>Total International Equity</b>		<b>\$1,410,181,135</b>	<b>12.05%</b>	<b>Yes</b>
Domestic Investment-Grade Fixed-Income	Banc One	\$224,151,674	1.92%	
Domestic Investment-Grade Fixed-Income	Earnest Partners	\$225,830,423	1.93%	
Domestic Investment-Grade Fixed-Income	Peregrine	\$211,871,297	1.81%	
Domestic Investment-Grade Fixed-Income	TCW	\$267,157,260	2.28%	
<b>Total Domestic Investment-Grade Fixed-Income</b>		<b>\$929,010,654</b>	<b>7.94%</b>	<b>No</b>
High Yield Fixed-Income	Fountain	\$165,689,172	1.42%	
High Yield Fixed-Income	Nicholas-Applegate	\$177,503,145	1.52%	
High Yield Fixed-Income	Seix	\$236,656,831	2.02%	
High Yield Fixed-Income	Shenkman	\$238,133,212	2.04%	
<b>Total High Yield Fixed-Income</b>		<b>\$817,982,360</b>	<b>6.99%</b>	<b>Yes</b>
Global Fixed Income	Brandywine	\$329,929,001	2.82%	
Global Fixed Income	Julius Baer	\$317,049,530	2.71%	
<b>Total Global Fixed Income</b>		<b>\$646,978,531</b>	<b>5.53%</b>	<b>Yes</b>
<b>Total Private Equity*</b>		<b>\$1,433,141,536</b>	<b>12.25%</b>	<b>No</b>
<b>Total Real Estate*</b>		<b>\$528,354,287</b>	<b>4.52%</b>	<b>Yes</b>
<b>Total Mezzanine Debt*</b>		<b>\$301,689,301</b>	<b>2.58%</b>	<b>No</b>
<b>Cash and Other Investments</b>		<b>\$129,404,751</b>	<b>1.11%</b>	<b>Yes</b>
<b>Total</b>		<b>\$11,699,821,663</b>	<b>100.0%</b>	
<b>Note:</b> *For more information on managers in these asset classes, refer to Exhibit 12 and Exhibit 13 on page 46 and Exhibit 14 and Exhibit 15 on page 45. <b>Source:</b> Prepared by legislative auditor's staff using information contained in TRSL's Total Portfolio Detail within the Investment Performance Report for the period ending June 30, 2004, and TRSL's investment policy.				



## **HOW DO TRSL'S MONEY MANAGER, CONSULTANT, AND CUSTODIAL FEES AND CHARGES COMPARE TO OTHER PENSION PLANS?**

The vast majority of fees TRSL is paying to money managers of traditional assets are lower than the median fees obtained from one fee survey. However, about half of the fees TRSL pays these same money managers are above the average fees obtained from another fee survey. These two surveys were prepared by the Independent Consultants Cooperative (ICC) and Greenwich Associates of Greenwich, Connecticut (Greenwich).

TRSL's consultant fees were higher than the Greenwich averages. According to TRSL's CIO, this situation is due to the system's large allocation to the alternative investments asset class. See page 29 for further discussion on the fees paid for alternative assets.

The annual fees TRSL pays to its custodian are lower than averages we obtained from the Greenwich survey.

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### **TRSL's Money Management Fees for Traditional Investments Are Mostly Lower Than the Median Fees in One Survey**

To determine whether the fees paid to TRSL's money managers were in line with averages paid by other retirement systems, we compared them to two fee surveys:

- An ICC study dated December 2003: The ICC is a consortium of independent investment consulting firms and its study was based upon an extensive survey of management fees paid by clients of consulting firms that belong to the ICC.
- Greenwich study dated July 2004: The Greenwich survey included 191 institutional investors and was prepared on behalf of a leading investment consultant firm during January and February 2004.

Using the ICC survey, TRSL fees in all survey asset classes are lower than the survey, as illustrated in Exhibit 9 on the following page. The ICC survey does not take into account the size of the plan. In fact, TRSL paid higher than median fees to only three of its 32 money managers.

# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

Exhibit 9 Comparison of TRSL Fees to ICC Survey of Money Managers' Fees (Public Defined Benefit Plans, Regardless of Plan Size)					
Asset Class	Median Fees per Survey (in basis points*)	TRSL Money Manager's Fees (in basis points)	Percentage That TRSL Is Above or Below Fee Study	Difference (in basis points)	Estimate Value of Difference in Fees**
Large Cap	46	26.3 (Deutsche)	42.8% Below	-19.7	-\$615,330
		22.8 (LSV)	50.4% Below	-23.2	-\$822,494
		2.5 (Rhumblin)	94.6% Below	-43.5	-\$1,477,409
		2.5 (Rhumblin)	94.6% Below	-43.5	-\$1,363,216
		24.6 (Bear Stearns)	46.5% Below	-21.4	-\$464,336
		19.2 (UBS)	58.3% Below	-26.8	-\$869,043
		19.7 (Atlanta)	57.2% Below	-26.3	-\$936,951
		17.0 (Furman Selz)	63.0% Below	-29.0	-\$881,353
		17.0 (Goldman Sachs)	63.0% Below	-29.0	-\$1,017,571
		23.1 (Smith Asset)	49.8% Below	-22.9	-\$822,820
Mid Cap	60	31.8(Ariel)	47.0% Below	-28.2	-\$958,879
		40.0(EBS)	33.3% Below	-20.0	-\$435,623
		32.4 (FLA)	46.0% Below	-27.6	-\$684,612
		32.2 (Seneca)	46.3% Below	-27.8	-\$773,756
Small Cap	87	60.0 (Boston )	31.0% Below	-27.0	-\$309,266
		59.1 (Rothschild)	32.1% Below	-27.9	-\$615,573
		57.0 (Systematic)	34.5% Below	-30.0	-\$637,878
		55.5 (Bank of NY)	36.2% Below	-31.5	-\$710,093
		60.0 (TCW)	31.0% Below	-27.0	-\$813,265
International	48	30.8 (Artisan)	35.8% Below	-17.2	-\$796,321
		19.4 (New Star)	59.6% Below	-28.6	-\$1,639,071
		32.4 (TT)	32.5% Below	-15.6	-\$564,941
Fixed Income	31	32.3 (Fountain)	4.2% Above	1.3	\$21,506
		31.8 (Applegate)	2.6% Above	0.8	\$14,181
		29.2 (Seix)	5.8% Below	-1.8	-\$42,635
		35.0 (Shenkman)	12.9% Above	4.0	\$95,255
		17.2 (TCW)	44.5% Below	-13.8	-\$368,923
		19.3 (Brandywine)	37.7% Below	-11.7	-\$385,568
		18.5 (Julius Baer)	40.3% Below	-12.5	-\$397,159
		14.8 (Banc One)	52.3% Below	-16.2	-\$364,466
		15.2 (Earnest)	51.0% Below	-15.8	-\$359,017
		13.3 (Peregrine)	57.1% Below	-17.7	-\$375,228
<b>Notes:</b> *Basis points: 100 basis points = 1 percent. **Calculated by taking the amount of assets under management as of June 30, 2004, multiplied by the difference between the actual fee paid compared to the average fee in the survey. For the full names of TRSL's money managers, refer to Exhibit 8 on page 24. <b>Source:</b> Prepared by legislative auditor's staff using an ICC Fee Survey (dated December 2003), TRSL's contracts with money managers, and manager invoices to TRSL for the 4 <sup>th</sup> quarter of fiscal year 2004.					

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## FEES PAID TO INVESTMENT PROFESSIONALS

Using the Greenwich survey and comparing to similar sized public pension plans, the fees TRSL pays for most (17 of 32, or 53%) of its money managers are higher than survey averages, as illustrated in Exhibit 10 on the following page. Specifically, the fees for a majority of TRSL's active domestic equity and active fixed income asset classes are higher than the survey averages.

The fees for 15 of 32 managers (47%) were below survey averages. Specifically, the fees for TRSL's passive domestic equity and active international equity were lower than survey averages.

# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

Exhibit 10 Comparison of TRSL Fees to Greenwich Survey of Investment Managers' Fees (Public Pension Plans With Assets Over \$5 Billion)					
Asset Class	Average Fees Per Survey (in basis points*)	Fiscal Year 2004 TRSL Investment Managers' Fees (in basis points)	Percentage That TRSL Is Above or Below Fee Study	Difference (in basis points)	Estimated Annual Value of Difference in Fees **
Active Domestic Equity	29.4	26.3 (Deutsche)	10.5% Below	-3.1	-\$96,829
		22.8 (LSV)	22.4% Below	-6.6	-\$233,985
		24.6 (Bear Stearns)	16.3% Below	-4.8	-\$104,150
		19.2 (UBS)	34.7% Below	-10.2	-\$330,755
		31.8 (Ariel)	8.2% Above	2.4	\$81,607
		40.0 (EBS)	36.1% Above	10.6	\$230,880
		60.0 (Boston )	104.1% Above	30.6	\$350,502
		59.1 (Rothschild)	101.0% Above	29.7	\$655,287
		57.0 (Systematic)	93.9% Above	27.6	\$586,847
		19.7 (Atlanta)	33.0% Below	-9.7	-\$345,568
		17.0(Furman)	42.2% Below	-12.4	-\$376,855
		17.0 (Goldman)	42.2% Below	-12.4	-\$435,099
		23.1 (Smith)	21.4% Below	-6.3	-\$226,365
		32.4 (FLA)	10.2% Above	3.0	\$74,414
		32.2 (Seneca)	9.5% Above	2.8	\$77,932
		55.5 (Bank NY)	88.8% Above	26.1	\$588,363
		60.0 (TCW)	104.1% Above	30.6	\$921,701
Passive Domestic Equity	3.1	2.5 (Rhumblin)	19.4% Below	-0.6	-\$20,378
		2.5 (Rhumblin)	19.4% Below	-0.6	-\$18,803
Active International Equity	39.7	30.8 (Artisan)	22.4% Below	-8.9	-\$412,050
		19.4 (New Star)	51.1% Below	-20.3	-\$1,163,397
		32.4 (TT)	18.4% Below	-7.3	-\$264,363
Active Fixed Income	14.9	32.3 (Fountain)	116.8% Above	17.4	\$287,845
		31.8 (Applegate)	113.4% Above	16.9	\$299,573
		29.2 (Seix)	96.0% Above	14.3	\$338,715
		35.0 (Shenkman)	134.9% Above	20.1	\$478,658
		17.2 (TCW)	15.4% Above	2.3	\$61,487
		19.3 (Brandywine)	29.5% Above	4.4	\$145,000
		18.5 (Julius Baer)	24.2% Above	3.6	\$114,382
		14.8 (Banc One)	0.7% Below	-0.1	-\$2,250
		15.2 (Earnest)	2.0% Above	0.3	\$6,817
		13.3 (Peregrine)	10.7% Below	-1.6	-\$33,919
Notes: *Basis points: 100 basis points = 1 percent. ** Calculated the difference in fees by multiplying the difference in basis points by the market value as of June 30, 2004, obtained from TRSL's Investment Report. Source: Prepared by legislative auditor's staff using information obtained from Greenwich Associates, TRSL's contracts with money managers, and other information obtained from TRSL.					

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## FEES PAID TO INVESTMENT PROFESSIONALS

According to TRSL's CIO, the Greenwich survey does not separate small and large cap in some of the asset classes it uses. Small cap management fees are higher than large cap fees, so it is important to differentiate between these two classes when comparing fees. Also, the Greenwich survey fixed income class is not broken into more than one category. The fixed income class includes high yield and global bond fund managers, which typically have higher fees than domestic fixed income managers. However, we found limited comparative data to use in our fee comparisons.

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### TRSL's Consultant Fees Are Higher Than Average

TRSL paid its three consultants \$507,749 in fiscal year 2004. Similarly sized public pension plans (more than \$5 billion in size) pay their consultants an average of \$275,000, according to the Greenwich survey. Thus, TRSL pays 85% more in consultant fees than the average paid by similar sized public retirement systems.

According to TRSL's CIO, TRSL's use of alternative investments is the primary reason for the system's high consultant fees. One of the system's consultants was hired exclusively to deal with alternative investments, and this consultant is paid \$300,000 per year by TRSL.

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### TRSL's Custodian Fees Are Lower Than Average

TRSL paid its custodian \$786,062 in fiscal year 2004. Similarly sized public pension plans (more than \$5 billion in size) pay their custodians an average of \$1,300,000, according to the Greenwich survey. Thus, TRSL pays 40% less in custodian fees than the average paid by similar sized public retirement systems.

Exhibit 11 shows the fees that TRSL paid its investment managers, consultant, and custodian during fiscal year 2004.

Exhibit 11 Fees Paid by TRSL to Its Investment Professionals Fiscal Year 2004		
Type of Professional	Amount of Fees	As Percentage of Total Assets (in Basis Points)
Investment Managers <sup>1</sup>	\$72,712,697	52.2 <sup>1</sup>
Investment Consultant	\$507,749	0.4
Custodian Bank	\$786,062	0.6
<b>Notes:</b> Total assets were \$13,940,066,773, as of June 30, 2004. Basis points: 100 basis points = 1 percent. <sup>1</sup> Includes alternative investment expenses and other investment manager fees. <b>Source:</b> Prepared by legislative auditor's staff using TRSL's fiscal year 2004 audited financial statement and the board approved operating budget.		

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## **DOES TRSL USE COMPETITIVE, OBJECTIVE PROCEDURES WITH PERFORMANCE BASED CRITERIA TO SELECT INVESTMENT MANAGERS, INVESTMENT CONSULTANTS, AND CUSTODIAN?**

Although TRSL uses competitive, objective procedures with performance based criteria to select its custodian, consultants, and public portfolio investment managers, its policies and procedures could be improved. TRSL's selection policies and procedures for its custodian, consultants, and public portfolio investment managers are in line with most, but not all, of the industry standard criteria recommended by the GFOA. However, we found that TRSL did not have some of the GFOA recommended documentation related to certain investment adviser searches. TRSL also selected one public portfolio investment manager without conducting on site due diligence. Finally, we found that TRSL does not have formal written duties and responsibilities for its custodian and consultants collected into a single policy document.

TRSL has separate policies for its public and alternative asset investment portfolios because TRSL does not use a Request for Proposal (RFP) process when selecting its alternative asset investment managers. TRSL's current policies and procedures for selecting alternative investment managers have improved from those used in guiding the selection of TRSL's alternative investment managers before August 2001. TRSL did not hire alternative investment managers from August 2001 until January 2005.

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### **TRSL's Policies and Procedures for Selecting Public Portfolio Investment Managers, Consultants, and Custodian Need Improvement**

We found that TRSL uses appropriate criteria for the selection of public portfolio money managers, custodian, and consultants including the following:

- Overview of organization and its key personnel--experience and education
- Investment approach and philosophy
- History of investment performance versus appropriate benchmarks
- Portfolio characteristics
- Fee structure

However, TRSL's selection methodologies adhered to most, but not all, GFOA criteria. We reviewed three of TRSL's searches for a custodian, consultant, and investment manager. For the custodian and consultant searches, we could not locate documentation of any staff summaries/analyses of the respondents for use by the board of trustees to review and choose the finalists. Without this documentation, we could not determine what information the board used

to make its choices for the finalists in these searches. The GFOA recommended criteria state that responses to a RFP should be analyzed and all RFP respondents should be independently scored.

Also, we found that TRSL did not conduct due diligence on-site visits to the finalists of a public portfolio investment manager search. The GFOA recommended criteria state that due diligence, which can include on-site visits, must be performed on candidates. On-site visits allow the system to evaluate a candidate's operations first-hand and thereby make a more informed decision regarding selection of the candidate.

Finally, TRSL has not placed the duties and responsibilities for its custodian and three consultants in a formal policy document. The GFOA recommended criteria provide that the duties and responsibilities of investment advisers (managers, custodians, and consultants) should be clearly stated in writing before a RFP/selection process begins. Without formal written duties and responsibilities, a system cannot pre-determine what is expected of an adviser before a search is begun, as well as after the adviser is hired.

**Recommendation 6:** TRSL staff should better organize and keep all documents related to its due diligence activities during search/selection processes.

**Management's Response:** We partially agree, in that we believe that TRSL maintains adequate due diligence documentation to support all decisions. However, we continuously strive to improve TRSL operations in all respects and will better document due diligence activities in the future (see Appendix D for TRSL's full response).

**Recommendation 7:** TRSL should adopt written general descriptions of duties and responsibilities for its custodian and each of its three consultants. These duties and responsibilities should be placed in the board's policies.

**Management's Response:** We agree with this recommendation (see Appendix D for TRSL's full response).

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### **TRSL Has Improved Its Policies and Procedures for Selecting Alternative Asset Investment Managers**

For alternative investment manager searches conducted before August 2001, TRSL's alternative investment selection policy provided an overview of the selection/due diligence process but did not dictate the criteria to be addressed during the due diligence process. However, during TRSL's hiring freeze for alternative investment managers (from August 2001 until January 2005), the board selected a new consultant whose sole focus is alternative investments. This consultant created, and the TRSL board approved, a strategic plan for TRSL's alternative investment portfolio. The strategic plan includes selection criteria for alternative investment managers.



We reviewed the investment committee minutes and other selection documents for the selection process for two alternative investment managers from before August 2001 and the selection process of TRSL's most recent alternative investment manager hired in January 2005. We found deficiencies in the selection processes for the two managers hired before August 2001, but none for the manager hired in 2005. The two earlier selection processes did not meet certain GFOA selection criteria because at the time TRSL did not have the proper investment guidelines in place. Since the hiring of these managers, TRSL has revised its alternative investment guidelines, which now comply with GFOA criteria. Our review also found that TRSL's new alternative investment consultant conducted a more detailed due diligence process than TRSL's previous consultant.

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### **DOES TRSL USE OBJECTIVE PROCEDURES WITH PERFORMANCE BASED CRITERIA TO MONITOR INVESTMENT MANAGERS (INCLUDING INVESTMENT PERFORMANCE AND CHURNING), INVESTMENT CONSULTANTS, AND CUSTODIAN?**

TRSL uses objective procedures and has properly monitored its investment managers. TRSL does monitor whether investment managers are churning the assets held in their accounts. However, TRSL does not adequately monitor investment managers' use of affiliated brokers. TRSL has properly monitored its consultants but should improve monitoring its custodian bank.

There are monitoring policies for the investment managers. However, no written policies are in place for the prevention of churning and the formal annual review of the consultants' and custodian's performance.

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### **TRSL Effectively Monitors Investment Manager Performance**

GFOA states that retirement systems should continually monitor the work of investment managers and that systems do the following:

- Compare performance to relevant benchmarks and peer groups
- Determine if the firm's investment team is still in place
- Determine if the firm uses a consistent management approach (does not change style frequently)

TRSL has complied with GFOA's recommendations and has effectively monitored investment manager performance. For example, TRSL compares the performance of the investment managers to relevant benchmarks on monthly, quarterly, year-to-date, and since inception intervals. However, the rates of return reported for the investment managers who invest in publicly-traded stocks and bonds are gross of fees. That is, the returns have not been adjusted downward to reflect the quarterly payments made by TRSL to investment managers for their services. In addition, each month TRSL requires each investment manager to report on portfolio characteristics and sector weightings of the portfolio.

TRSL communicates frequently with its consultant and the investment managers to keep abreast of any personnel changes. Statistical measures are also compiled by the consultant on the assets in the investment manager portfolios to help the TRSL board of trustees and staff monitor for any changes in a manager's investment style. Finally, TRSL's investment policy has requirements for monitoring investment managers.

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### **TRSL Monitors to Prevent the Churning of Assets by Its Investment Managers**

Churning is the practice of excessive trading in an account, which increases the commissions earned by the broker handling the trades. TRSL has several controls in place to guard against churning by its investment managers. First, managers are paid by TRSL based on the amount of assets they have under management. This provision provides managers with an incentive to increase the value of the account being managed for TRSL. The second control used by TRSL is that commissions are paid out of the account overseen by the investment manager. In practice, since churning increases the commissions that must be paid to a broker, this would reduce the value of the account and thus lower the fee earned by the manager.

With these controls in place, churning would probably only occur if the manager were getting some financial incentive from the broker to churn the account or if the manager and broker were affiliated in the same financial services company. TRSL uses a third control during the investment manager search process. TRSL's staff and its consultant evaluate whether a potential manager has affiliated brokers. However, no provisions are in place to ensure that trades are not executed by affiliated brokers once the manager is hired.

A manager's turnover ratio is another method used by TRSL on an annual basis to evaluate whether churning is occurring. A high turnover ratio could indicate churning by the manager. We reviewed the trading activity of three managers for a quarter during fiscal year 2004 and found no evidence of churning.

While TRSL does monitor its investment managers for the churning of assets, none of these monitoring practices are contained in TRSL's written policies.

**Recommendation 8:** TRSL should include a prohibition against using affiliated brokers in its investment manager contracts and review trading activity once a manager is hired to ensure that affiliated brokers are not used.

**Management's Response:** We partially agree, in that trading with affiliated brokers should be prohibited in most cases. However, with regard to international investment managers, best execution can sometimes be significantly harmed by such prohibitions. We will continue to use a global transaction measurement service to monitor all managers' trading for best execution (see Appendix D for TRSL's full response).

**Recommendation 9:** TRSL should formalize its current practices for monitoring investment managers for the churning of TRSL assets into its written policies.

**Management's Response:** We disagree, since TRSL presently addresses in the investment policy the monthly review of investment managers, which includes a review of their trading results, as deemed necessary (see Appendix D for TRSL's full response).

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### TRSL Monitors Its Consultants

TRSL has implemented a formal, annual evaluation of the system's consultants. The evaluation is based on factors such as the effectiveness of communication, the adequacy of the information provided to the board, the quality and timeliness of the reports, and the impartiality of recommendations. In addition, the TRSL staff and board of trustees also have frequent interactions with the consultants and through this less formal process monitor the consultants and convey their expectations to them.

The formal evaluation of consultants is not, however, in TRSL's written policies. Written policies would help ensure that there is continuity and consistency of consultant monitoring. The policy should specify the frequency of evaluations and the criteria to be used in an evaluation.

**Recommendation 10:** TRSL should formalize its current practices for evaluating its consultants into its written policies.

**Management's Response:** We partially agree. We agree that an annual review of the consultant is needed, which we presently perform. However, we disagree that this recommendation is needed, since the Board of Trustees, by formal resolution, requires the annual evaluation of all investment consultants (see Appendix D for TRSL's full response).

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### TRSL Monitors Its Custodian Bank, but Does Not Have a Formalized Evaluation Process

TRSL monitors its custodian by requiring its investment managers to reconcile their records and submit a reconciliation certification to TRSL. TRSL's staff members also reconcile the records of the custodian on a monthly basis. These reconciliation processes help to ensure that any breakdown in the custodial system between annual audits will be identified on a timely basis.

However, TRSL does not have a policy or procedure to formally evaluate its custodian on a regular basis. GFOA criteria provide that a retirement system should monitor its custodian based on the bank's focus on custodial business (as compared to other types of banking services), the custodian's handling of problem transactions, and the financial health of the custodial bank. TRSL's CIO stated that TRSL recently replaced its custodian because of, among other things, the custodian's handling of problem transactions. A formal evaluation of the custodian using predetermined criteria would help ensure the custodian focuses on areas to improve service and/or broaden the services provided to TRSL. It could also verify the financial condition of the custodian.

**Recommendation 11:** TRSL should develop and implement written policies and procedures for formal custodial reviews (at least annually). These policies and procedures should state the frequency of evaluations and the areas to be evaluated.

**Management's Response:** We partially agree with the recommendation, since TRSL, although not formally, already monitors the custodian and takes corrective actions as needed. TRSL will formally review the custodian annually and will require such by Board resolution or in policy (see Appendix D for TRSL's full response).

### **IF PERFORMANCE BY INVESTMENT MANAGERS, INVESTMENT CONSULTANTS, OR CUSTODIANS IS BELOW RELEVANT BENCHMARKS, DOES TRSL TAKE CORRECTIVE ACTION?**

TRSL takes corrective action for poorly performing money managers and for the system's custodian. TRSL has not had to take corrective action against any of its three consultants, one of which has been TRSL's consultant since 1990. We found TRSL has few policies relating to corrective action for underperforming managers, consultants or custodians.

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#### **TRSL Takes Corrective Action When Investment Managers Underperform**

According to TRSL's staff and system documents, TRSL takes corrective action against poor performing investment managers. We reviewed TRSL's non-alternative investment managers' performance from fiscal year 2001 through 2004 and found four managers underperformed their relevant benchmark for at least three consecutive fiscal years. TRSL terminated two of these managers, and another manager will be replaced in April 2005. TRSL's staff stated that they have not terminated the fourth manager because the system does not allow the manager to invest in certain high risk investments. From 2001 through 2004, these investments performed extremely well and were included in the benchmark, thus causing the manager to miss the benchmark.

TRSL has few formal written corrective action policies in place for poor performing non-alternative investment managers and therefore determines corrective action on a case by case basis. TRSL's lack of corrective action policies may result in inconsistent corrective action toward different managers and/or in giving underperforming managers too much time to improve their performance before terminating them. The GFOA recommended criteria state that retirement systems should develop policies to govern placing money managers on a watch list or terminating them for reasons such as key personnel changes, portfolio characteristics, underperformance, and style deviations.

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#### **TRSL Takes Corrective Action When Its Custodian Underperforms**

TRSL took corrective action against its custodian in September 2003 because of its concerns over the custodian's information system and organizational changes. TRSL conducted a custodian search and hired a new custodial bank in September 2003. GFOA recommended criteria state that the process of changing custodians should only occur over planned intervals and should not be initiated in reaction to financial hardship of the current custodian. TRSL met this criterion because it did not change its custodian due to the custodian having financial hardships, and the system completed the process of changing custodians over planned intervals.

TRSL does not have any formal written policies concerning corrective action for its custodian or consultants. TRSL's staff stated that all of TRSL's contracts contain a termination clause, which allows either party to terminate the contract without cause upon notice to the other party.

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### **TRSL Has Not Needed Corrective Action for Its Consultants**

TRSL has not had to take any corrective action against the system's three consultants. TRSL has employed one consultant since 1990, and hired two additional consultants in October 2003. GFOA recommended criteria emphasize the importance of independence and objectivity between consultants and managers. TRSL informed us that it has had no concerns regarding the consultants' independence and objectivity.

**Recommendation 12:** TRSL should formalize its current practices related to corrective action against investment managers into its written policies.

**Management's Response:** We partially agree, in that written policies may help someone outside of TRSL to understand the process. We will include general statements in policy concerning corrective actions against investment managers. However, evaluating the performance of and taking corrective action with regard to investment managers will continue to be done on a case-by-case basis, since no simple set of rules in a policy can address very complex and unique situations (see Appendix D for TRSL's full response).



## WHAT ROLE DO ALTERNATIVE INVESTMENTS PLAY IN TRSL'S INVESTMENT PORTFOLIO?

TRSL has alternative investments in private equity, real estate, and mezzanine debt totaling almost \$2.26 billion, as of June 30, 2004, which constituted 19.3% of TRSL's investment portfolio. Alternative investments have historically produced higher rates of return than more traditional investments. TRSL's overall rates of return (net of fees) for alternative investments are 5.4% for a five-year period and 9.2% over a 10-year period. The approximate rates of return, net of fees, for a five-year period ending on June 30, 2004, were 7.50% for international private equity, 2.02% for domestic private equity, 8.19% for real estate, and 13.09% for mezzanine debt. Alternative investments also provide diversification to a portfolio because they may not move in the same direction as other types of investments.

Alternative investments have higher management fees than traditional investments. Another disadvantage of these investments is their illiquidity. TRSL's investments with alternative managers can be tied up for five years or longer. Also, these investments have other risks that traditional investments do not have.

The percentage of TRSL's portfolio allocated to alternative investments is significantly higher than an average of public retirement systems in the U.S. TRSL's percentage of alternative investments is also higher than five other state systems comparable in asset size to TRSL.

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### Alternative Investments Are Different From Traditional Investments

TRSL's alternative investments total approximately \$2.26 billion, as of June 30, 2004, which constituted 19.3% of TRSL's investment portfolio. Of TRSL's portfolio, private equity funds comprise 12.25%, real estate 4.52%, and mezzanine debt funds comprise 2.58%. A description of the different types of alternative investments follows.

**Private equity** investments attempt to take advantage of opportunities in the private markets, by investing in business ventures. Private equity refers to investments other than direct investments in publicly traded equities and bonds, mutual funds, or certificates of deposit. Some categories of private equity investments are as follows:

- **Venture capital** refers to funds made available to start-up firms and small businesses with exceptional growth potential. Such investing usually means buying early ownership in a company.
- **Leveraged buyouts** take place with the acquisition of a company or a division of a large corporation, using borrowed funds.

**Real estate** investments are in properties such as apartment or office buildings, shopping centers, and hotels.

**Mezzanine debt** is debt that incorporates equity-based options, such as warrants, with a lower-priority debt. It is actually closer to equity than debt, in that the debt is usually only of importance in the event of bankruptcy. Mezzanine debt is often used to finance acquisitions and buyouts, where it can be used to prioritize new owners ahead of existing owners in the event that a bankruptcy occurs.

A typical alternative investment vehicle is a limited partnership. Such a partnership has a general partner who manages the investments owned by the partnership. The investing retirement systems are the limited partners of a partnership. If the partnership is formed for direct private equity investing, it may invest in 20 to 30 business ventures.

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### Advantages and Disadvantages of Alternative Investments

Alternative investments provide portfolio diversification because many of them are not highly correlated with the typical investment held by TRSL (i.e., they do not always move in the same direction). If the stock or bond markets go down, the alternative investments may not go down as much or may move in the opposite direction and increase in value. A second advantage is the above-average returns these investments have historically produced.

One disadvantage of alternative investments is that their management fees exceed the fees charged for non-alternative investments. The reason alternative investment managers can command a higher fee is the historically higher rates-of-returns they have provided. Some of these funds also charge a performance or incentive fee in addition to the normal fee (percentage of assets under management). These performance fees usually take the form of a percentage of the profits that reduces the profits shared by other investors.

Other risks of alternative investments include:

- A lack of liquidity for investments made by the manager because the investments are made for a long-term.
- A lack of liquidity of an investor's interest. An investor is usually unable to withdraw from the investment or sell its interest; thus, an investor's funds may be tied up until (if) the investment manager makes distributions.
- No assurance that the investments will be profitable because the investments have a high degree of business and financial risk. An investor could lose all of the funds invested.
- No investor input into management or the conduct of day-to-day business. The manager of a fund typically makes all the decisions concerning investments, and investors have no vote or other means of control over the manager's decisions.

- Reliance on key personnel of the manager. If one or more of these personnel leave, the fund's performance could be adversely affected.
- No assurance that investments will be diversified.

Another concern related to alternative investments is that their reported rates of return may not be accurate and reliable. The fair market values of an alternative investment's assets are used to calculate the investment's rate of return. Many of these assets are privately held and not traded like securities on a public exchange where a fair market value is readily determinable. Different techniques can be used to value these assets, which can result in two different investment managers valuing the same asset at differing values. Since the accuracy of these assets' fair market values is questionable, the rates of return reported for alternative investments may not be accurate and reliable.

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### **Rates of Return of Alternative Investments**

The overall rate of return for private equity investments, net of fees, for a five-year period is approximately 7.5% for international funds and 2.0% for domestic funds. The rates of return for TRSL's international private equity funds for the past one, three, and five years are shown in Exhibit 12 on the following page. The rates of return for TRSL's domestic private equity funds for the past one, three, and five years are shown in Exhibit 13 on the following page. Private equity funds can take as long as 10 years to mature and liquidate, according to TRSL officials. Therefore, using a five-year (and shorter) horizon to measure performance may be misleading. Most of the private equity partnerships TRSL is currently invested in have existed for five years or less. The exceptions are noted in the footnotes to each exhibit.

Comparable benchmarks are not as readily available for alternative investments as they are for traditional investments. For example, in the system's investment reports, TRSL does not compare the performance of its alternative asset classes (venture capital, corporate finance/buyout, real estate, and mezzanine debt) to specific benchmarks. Rather, the total of all the system's alternative investments are compared to one general benchmark. The CIO explained that this comparison is done because the benchmark indices that are available contain funds with different start-up dates and to compare apples to apples, funds must have the same start-up dates.

<b>Exhibit 12</b> <b>TRSL's Alternative Investments' Performance</b> <b>Rates of Return for International Private Equity Investments</b> <b>(As of June 30, 2004)</b>			
<b>Investment Manager</b>	<b>1 Year Percentage</b>	<b>3 Years Percentage</b>	<b>5 Years Percentage</b>
Compass Eur Equity Fund LP	9.63	0.58	0.35
Deutsche Euro IV LP	-38.04	-15.68	N/A
Doughty Hanson III LP	26.99	15.96	14.45
Second Cinven Fund US LP	10.74	12.44	9.32
Warburg Pincus International LP	19.67	3.28	N/A
<b>Total International Private Equity</b>	<b>9.97</b>	<b>8.33</b>	<b>7.50</b>
S&P 500 PLUS 4% BENCHMARK	23.11	3.31	1.83
<b>Source:</b> Prepared by legislative auditor's staff using TRSL's Total Portfolio Detail within the Investment Performance Report for the period ending June 30, 2004.			

<b>Exhibit 13</b> <b>TRSL's Alternative Investments' Performance</b> <b>Rates of Return for Domestic Private Equity Investments</b> <b>(As of June 30, 2004)</b>			
<b>Investment Manager</b>	<b>1 Year Percentage</b>	<b>3 Years Percentage</b>	<b>5 Years Percentage</b>
Apollo Invst Fd III LP *	66.65	19.16	16.84
Apollo Invst Fd IV LP	25.70	8.12	9.30
Apollo Invst Fd V LP	28.17	31.46	N/A
Bear Stearns II LP	4.63	-7.90	N/A
Brera Capital LP	32.25	14.83	-4.41
Carlyle III LP	52.48	22.19	N/A
CSFB Equity LP	2.85	-21.60	N/A
DLJ Merchant Bank LP	47.56	17.49	N/A
Heartland LP	0.52	1.10	N/A
Hicks, Muse Eq Fd III LP *	-0.31	-11.99	-11.24
Hicks, Muse Eq Fd IV LP	-8.43	-17.80	-11.89
Hicks, Muse Eq Fd V LP	46.83	18.52	N/A
Pharos LP	8.08	-2.95	N/A
Warburg Pincus Eq LP	43.38	6.29	8.04
Horsley Bridge VII LP	-5.82	-22.19	N/A
Special Private Equity	-1.68	-12.57	N/A
<b>Total Domestic Private Equity</b>	<b>21.70</b>	<b>1.41</b>	<b>2.02</b>
S&P 500 PLUS 4% BENCHMARK	23.11	3.31	1.83
<b>Note:</b> *The rate of return for a 7-year period for Apollo Investment Fund III LP is 15.07% and for Hicks, Muse Eq Fund III LP is -0.58%. <b>Source:</b> Prepared by legislative auditor's staff using TRSL's Total Portfolio Detail within the Investment Performance Report for the period ending June 30, 2004.			

The approximate overall rate of return for real estate investments, net of fees, for five years is 8.2%. The rates of return for TRSL's real estate investments for the past one, three, and five years are shown in Exhibit 14 on the following page.

The approximate overall rate of return for mezzanine debt investments, net of fees, for five years is 13.1%. The rates of return for TRSL'S mezzanine debt investments for the past one, three, and five years are shown in Exhibit 15 below.

<b>Exhibit 14</b> <b>TRSL's Alternative Investments' Performance</b> <b>Rates of Return for Real Estate Investments</b> <b>(As of June 30, 2004)</b>			
<b>Investment Manager</b>	<b>1 Year Percentage</b>	<b>3 Years Percentage</b>	<b>5 Years Percentage</b>
DLJ Real Estate Cap II	40.07	20.41	N/A
Doughty Hanson	63.54	32.26	18.43
ING Realty	19.30	3.87	5.52
ING Realty II	25.32	12.46	N/A
Olympus Co-Invt	1.17	8.57	N/A
Olympus RE Fd II	-13.14	-8.65	-1.16
Olympus RE Fd III	3.61	.58	N/A
Starwood Gbl Fd VI	-26.31	N/A	N/A
Starwood Opp Fd IV*	118.81	39.14	27.06
Westbrook Sunstone Hotel	-2.09	1.32	N/A
Westbrook RE Fd III	34.40	10.03	12.45
Westbrook RE Fd IV	28.00	7.10	N/A
<b>Total Real Estate</b>	<b>16.94</b>	<b>7.72</b>	<b>8.19</b>
S&P 500 PLUS 4% BENCHMARK	23.11	3.31	1.83
<b>Note:</b> *The rate of return for a 7-year period for Starwood Opp Fd IV LP is 26.72%. <b>Source:</b> Prepared by legislative auditor's staff using TRSL's Total Portfolio Detail within the Investment Performance Report for the period ending June 30, 2004.			

<b>Exhibit 15</b> <b>TRSL's Alternative Investments' Performance</b> <b>Rates of Return for Mezzanine Investments</b> <b>(As of June 30, 2004)</b>			
<b>Investment Manager</b>	<b>1 Year Percentage</b>	<b>3 Years Percentage</b>	<b>5 Years Percentage</b>
1818 Mezzanine Fd	16.03	N/A	N/A
Audax Mezz Fd	30.98	7.67	N/A
Blackstone Mezz	40.13	15.62	N/A
DLJ Investment II	26.10	11.63	N/A
DLJ Real Estate Mezz*	16.13	10.74	10.92
Gleacher Mezz	48.15	14.61	N/A
Peninsula Fund III	17.28	N/A	N/A
Prudential Cap	14.07	9.25	N/A
TCW Cres Mezz III	48.26	17.36	N/A
<b>Total Mezzanine</b>	<b>28.07</b>	<b>15.16</b>	<b>13.09</b>
S&P 500 PLUS 4% BENCHMARK	23.11	3.31	1.83
<b>Note:</b> *The rate of return for a 7-year period for DLJ Real Est Mezz Cap LP is 9.65%. <b>Source:</b> Prepared by legislative auditor's staff using TRSL's Total Portfolio Detail within the Investment Performance Report for the period ending June 30, 2004.			

## TRSL Has a Higher Percentage of Alternative Investments Than Other Public Retirement Systems

Wilshire Consulting (Wilshire Associates Incorporated) publishes an annual survey of state retirement systems. In Exhibit 16 below, we compared TRSL's levels of alternative investments to averages obtained from the 2004 report of Wilshire Consulting. Exhibit 17 on the following page shows that when compared to other public retirement systems across the U.S., TRSL's percentage of real estate investments (4.4%) was slightly higher than the average (4.16%). TRSL's percentage of alternative investment holdings other than real estate (18.0%) was significantly higher than the average (4.68%). In fact, for alternative investments other than real estate, TRSL had the highest percentage of any state retirement system, according to the 2004 report of Wilshire Consulting. TRSL's total alternative investments decreased to 19.35% of the total portfolio, as of June 30, 2004.

<b>Exhibit 16</b> <b>Comparison of TRSL'S Alternative Investment Holdings to Other</b> <b>Public Retirement Systems</b> <b>Through June 30, 2003*</b>		
<b>Retirement System</b>	<b>Real Estate Investments as Percentage of Total Portfolio</b>	<b>All Alternative Investments Other Than Real Estate as Percentage of Total Portfolio</b>
TRSL	4.4	18.0
Average	4.16	4.68
High	13.70	18.0
Median	3.09	3.90
<b>Note:</b> *Some of the retirement systems' report dates included in these statistics were not as of June 30, 2003. <b>Source:</b> Wilshire Consulting (Wilshire Associates Incorporated): 2004 Wilshire Report on State Retirement Systems.		

We also compared TRSL to retirement systems that are similar in asset size to TRSL. Exhibit 17 shows a comparison of TRSL to these systems using data taken from the 2004 report of Wilshire Consulting. Of the six systems, TRSL had the largest percentage (18.0%) of holdings in alternative investments other than real estate. Two retirement systems in Michigan and Minnesota each had more than 13% in alternative investments other than real estate. For real estate holdings, two state systems had larger percentage holdings than TRSL.

<b>Exhibit 17</b> <b>Comparison of TRSL's Alternative Investment Holdings</b> <b>to Similar Sized Retirement Systems</b>			
<b>Retirement System</b>	<b>Reporting Date</b>	<b>Real Estate as Percentage of Total Portfolio</b>	<b>All Alternative Investments Other Than Real Estate as Percentage of Total Portfolio</b>
TRSL	6/30/2003	4.4	18.0
Illinois State Employees Retirement System	6/30/2003	8.0	6.0
Illinois State Universities Retirement System	6/30/2003	2.0	9.0
Kentucky Teachers Retirement System	6/30/2003	2.9	0.0
Michigan State Employees Retirement System	9/30/2003	9.6	13.3
Minnesota Public Employees Retirement Association	6/30/2003	0.0	13.9
<b>Source:</b> Wilshire Consulting (Wilshire Associates Inc.): Wilshire 2004 Report on State Retirement Systems.			

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**DOES TRSL EMPLOY ADEQUATE POLICIES AND PROCEDURES TO ENSURE THAT PRIMARY DECISION MAKERS (BOARD MEMBERS, KEY SYSTEM STAFF, MONEY MANAGERS, CUSTODIAN, AND CONSULTANTS) AVOID CONFLICTS OF INTEREST AS WELL AS THE APPEARANCE OF CONFLICTS OF INTEREST?**

The policies and procedures of TRSL may not always ensure that primary decision makers avoid conflicts of interest as well as the appearance of conflicts of interest. We found instances where gifts were accepted by TRSL's staff and consultant from investment managers, a possible violation of the Louisiana Code of Governmental Ethics. In addition, TRSL's trustees, staff, and consultant accepted meals from its investment managers, consultants, and custodian.

TRSL does employ some procedures to help ensure that investment managers and consultants avoid potential conflicts of interest. However, TRSL has not developed written policies for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest by investment managers and consultants.

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**TRSL Could Strengthen Controls to Prevent Conflicts of Interest by Its Key Staff and Trustees**

TRSL's policies and procedures may not always ensure that key staff members and trustees avoid potential conflicts of interest. As a result, we found that members of TRSL's staff and trustees may have violated the Louisiana Code of Governmental Ethics by accepting gifts from investment managers hired by TRSL.

We asked TRSL's investment managers, custodian, and consultants to identify any items of economic value provided to staff and trustees at TRSL during the period from July 1, 2003, through October 15, 2004 (15½ months). We also asked key staff members and trustees for a list of anything received from these investment professionals during the same time period. We found that the TRSL staff received Christmas baskets totaling \$160.00. Exhibit 18 on the following page shows the values of all gifts received by the TRSL staff, who provided it, and on what date. The Louisiana Code of Governmental Ethics (R.S. 42:1115) specifically provides that no public servant shall accept any thing of economic value as a gift from any person, if the public servant knows or should know that the person is seeking to obtain contractual or other business or financial relationships with the public servant's agency. A "thing of economic value" is defined as money or any other thing having economic value, except promotional items having no substantial resale value, according to R.S. 42:1102(22)(a).

We also found that trustees and staff received travel reimbursements in the amount of \$6,159.30 provided by some of the alternative investment managers. These managers pay the travel costs when someone from TRSL attends investment advisory committee meetings, which the TRSL staff note is required and contained in contracts. In addition, we found that investment managers gave \$1,100.00 to charities on behalf of the TRSL trustees and staff in lieu of gifts. It

## TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

is not clear whether travel reimbursements and charitable donations on behalf of the TRSL staff and trustees constitute a violation of the ethics code. Exhibit 19 lists the recipients and value of these travel reimbursements and donations.

<b>Exhibit 18</b> <b>Gifts Received by TRSL Personnel</b> <b>(From July 1, 2003, Until October 15, 2004)</b>				
Provider	Recipients	Gift	Value	Date
Systematic	Dan Bryant, Liz Guidry (staff)	Christmas Baskets from Harry and David's	\$160.00	12/1/2003
<b>Total</b>			<b>\$160.00</b>	
<b>Source:</b> Prepared by legislative auditor's staff using information provided by TRSL's key staff, board of trustees, investment managers, consultant, and custodian.				

<b>Exhibit 19</b> <b>Travel Reimbursements and Charitable Donations Received by TRSL Trustees and Personnel (From July 1, 2003, Until October 15, 2004)</b>				
Provider	Recipients	Item	Value	Date
Trust Company of the West	Dan Bryant (staff)	Hotel	\$950.00	10/1/2003
Peregrine	TRSL board	Contribution in lieu-of-gift to March of Dimes	\$1,000.00	12/1/2003
Olympus	Brendan Brosnan (staff)	Hotel*	\$350.00	12/9/2003
Boston Global Advisor	Bonita Brown, Paula Bezar; Dan Bryant, Graig Luscombe (staff)	Contribution in lieu-of-gift to Make a Wish Foundation	\$100.00	12/15/2003
ING Realty	Sheryl Abshire (Trustee)	Hotel	\$628.00	5/3/2004
Olympus	Brendan Brosnan (Staff)	Airfare	\$303.00	6/30/2004
Olympus	Dan Bryant (staff)	Hotel*	\$850.00	9/21/2004
Horsely Bridge Partners	Dan Bryant (staff)	Hotel	\$336.30	9/29-30/2004
Carlyle Group	Dan Bryant (staff)	Travel/Lodging	\$1,327.00	10/1/2004
Trust Company of the West	Brendan Brosnan (staff)	Hotel	\$1,000.00	10/6/2004
Olympus	Dan Bryant (staff)	Airfare	\$415.00	10/7/2004
<b>Total</b>			<b>\$7,259.30</b>	
<b>Note:</b> *Reported as hotel and meals but classified as hotel because we could not determine if the meals were eaten with investment managers' representatives. <b>Source:</b> Prepared by legislative auditor's staff using information provided by TRSL's key staff, board of trustees, investment managers, consultant, and custodian.				

Although some of TRSL's staff accepted gifts, TRSL does have policies concerning the ethics code. One policy requires training of board members regarding the ethics code. Another policy states that annually TRSL's trustees and key staff are required to attest to their compliance with the state ethics code. We reviewed documents that show that this policy has been implemented. However, it is evident that these policies may not have been properly communicated to all parties involved.

In addition, we asked TRSL's investment managers, custodian, consultants, key staff, and trustees to disclose any economic interests that trustees, TRSL staff, or their immediate family members have with any of the investment managers, custodian, or consultants. Based on the responses we received, we did not find any trustees, TRSL staff, or their immediate family members with any economic interests in the investment professionals hired by TRSL.

The TRSL staff and trustees are involved in screening, selecting, monitoring, and evaluating the investment managers hired by TRSL. Therefore, any gifts received by TRSL's staff and trustees from the investment managers could be viewed as attempts to influence TRSL's oversight decisions. To avoid this potential conflict of interest, the Louisiana Code of Governmental Ethics prohibits public employees from accepting any thing of economic value as a gift from anyone with a contractual or other business relationship with the public employee's agency. This code also prohibits TRSL from contracting with any investment manager, consultant, or custodian at which a trustee or key staff member or a member of their immediate family has a substantial economic interest (R.S. 42:1113).

**Recommendation 13:** TRSL should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of these gifts, travel reimbursements, and charitable donations constitute a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, TRSL should strengthen policies and procedures to ensure that all staff and trustees adhere to the Louisiana Code of Governmental Ethics. TRSL should clearly communicate the applicability of the ethics code to TRSL's trustees and staff and the provisions of the code to all investment managers.

**Management's Response:** TRSL's general counsel disagrees that any items listed are gifts in violation of ethics laws. TRSL staff will consult with the Board of Trustees on the necessity of obtaining an opinion from the Board of Ethics. The applicability of the ethics code has been, and continues to be, communicated clearly to all associated with TRSL (see Appendix D for TRSL's full response).

**Recommendation 14:** TRSL should strengthen policies and procedures to ensure that all trustees and staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers.

**Management's Response:** We disagree. TRSL already has in place policies and procedures more strict than the law requires, and these policies and procedures have been effective in preventing conflicts of interest (see Appendix D for TRSL's full response).

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### **TRSL's Staff, Trustees, and Consultant Have Accepted Meals From TRSL's Investment Managers, Consultants, and Custodian**

Senate Concurrent Resolution (SCR) No. 14 of the 2004 Regular Legislative Session provides that the legislature is concerned about any impropriety which may occur between investment consultants, advisors, managers and the board members of the state public retirement systems. SCR No. 14 therefore directed the legislative auditor to examine and audit all facets of the relationship among investment consultants, advisors, managers and board members of the systems. Accordingly, we asked trustees, key TRSL staff, and all of TRSL's investment advisors to inform us of meals paid for by investment advisors during the period from July 1, 2003, through October 15, 2004.

The prohibition against accepting any thing of economic value as a gift in the Louisiana Code of Governmental Ethics has exceptions. One such exception is for food, drink, or refreshments consumed by a public servant while the personal guest of some person [R.S. 42:1102(22)(a)]. According to the information reported by TRSL's investment managers, consultants, custodian, trustees, and key staff during the 15½-month period from July 1, 2003, through October 15, 2004, trustees, staff, and consultant accepted meals from investment managers, consultants, and custodian valued at \$51,598 (includes investment managers receiving meals). See Appendix C for more detailed information about the meals provided.

A few points should be noted regarding the meal information reported. First, most but not all persons contacted responded. Second, the dollar values of the meals reported in some cases include the cost of the investment manager's, consultants', or custodian's representative(s) who were present. Third, during the time period we reviewed, there was no requirement for trustees, staff, investment managers, custodian, or consultants to maintain records of meals provided or received. Therefore, the actual number and dollar values of meals received may be more or less than reported.

These meals do not violate the ethics code; however, they represent a potential conflict of interest for trustees and key staff. TRSL's trustees and key staff are involved in screening, selecting, evaluating, and replacing the investment managers, consultants, and custodian who work for TRSL. Therefore, meals provided by investment managers, consultants, and the custodian could be viewed as attempts to influence TRSL's oversight decisions. By addressing such situations, we are complying with the intention of SCR No. 14. The providers, recipients, total cost, and dates of the meals are shown in Appendix C on pages 59-64.

TRSL does have a procedure that automatically starts a "blackout period" in which a potential manager may not discuss an RFP with any trustee outside of board and committee meetings once that manager has been selected as a finalist for an investment manager contract. The "blackout" ends when the final selection has been made of who will get the contract. If managers are found to be in violation of the blackout period, they may forfeit their eligibility as a potential manager. However, we found two violations of the blackout period policy with what seems to be no negative recourse for one of the managers in violation as they were later hired. The TRSL officials commented that TRSL had an ongoing relationship with both managers in

question prior to the RFP period. Other than this “blackout period,” there is no limit on the frequency and dollar value of meals accepted by TRSL’s trustees and staff.

**Recommendation 15:** TRSL should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.

**Management’s Response:** We disagree. TRSL already has in place policies requiring staff, trustees, and consultants to follow ethics laws with regard to meals. For the record, at least 50 percent of the dollar value of meals reported by investment managers and consultants is for themselves and for their guests, not for TRSL trustees and staff. Evidence in your own report refutes the notion that a TRSL official accepting a meal has created a conflict of interest. The elected Trustees are unpaid volunteers who donate their time and talent. Having their integrity called in to question, when your report proves that their decisions are based on sound, objective factors, is disappointing. Be assured that TRSL will continue to follow the letter and the spirit of the ethics laws regarding meals (see Appendix D for TRSL’s full response).

**Legislative Auditor’s Additional Comments:** Management at TRSL states in its response that the elected trustees are unpaid volunteers who donate their time and talent. Most of the elected trustees are currently public employees who receive compensation from their government employer.

**Recommendation 16:** TRSL should strengthen its blackout period procedures to prohibit all contact between potential contractors and the trustees outside of board and committee meetings during the entire selection process regardless of prior relationships between the system and the contractors in question.

**Management’s Response:** We agree with this recommendation (see Appendix D for TRSL’s full response).

**Recommendation 17:** TRSL should add its blackout period provisions to the TRSL Board Governance policies to ensure that no violations occur and make all relevant parties aware of the policy.

**Management’s Response:** We agree with this recommendation (see Appendix D for TRSL’s full response).

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### **TRSL Does Not Have Policies to Ensure That Investment Managers Avoid Conflicts of Interest**

TRSL has practices in place to help ensure that investment managers avoid potential conflicts of interest. During the selection process, TRSL relies on disclosure provisions included in ADV forms and letters that are filled out by all potential managers for the disclosure of conflicts of interest from investment managers. However, these practices are not a part of TRSL’s written policies.

**Recommendation 18:** TRSL should develop and implement written policies to ensure that investment managers disclose and avoid any potential conflicts of interest.

**Management's Response:** We partially agree with this recommendation. Although TRSL presently requires disclosure of conflicts of interest in the hiring process, we will develop conflict of interest provisions to be included in future investment manager contracts (see Appendix D for TRSL's full response).

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### **TRSL Could Strengthen Controls on Disclosure and Treatment of Potential Conflicts of Interest by Its Consultant**

TRSL does not employ adequate policies or procedures to ensure disclosure and proper treatment of potential conflicts of interest with the consultants it hires. As a result, we found that one of TRSL's consultants has received gifts from some of TRSL's investment managers that may violate the Louisiana Code of Governmental Ethics. During the period from July 1, 2003, through October 15, 2004, these gifts of bottles of wine, outings (type of outing not specified), and golf had an estimated total value of \$827.00.

In a ruling dated January 8, 2004, the Louisiana Board of Ethics determined that the consultant for TRSL was a "public employee" of the retirement system as defined in the Louisiana Code of Governmental Ethics (Docket No. 2002-556). The ethics code prohibits public employees from accepting gifts from anyone with a contractual or other business relationship with the public employee's agency.

Recent legislation (Act 686 of 2004) requires investment managers and consultants to disclose conflicts of interest to public retirement systems and requires consultants to disclose any payments they receive from investment managers, in hard or soft dollars, for any services they provide. According to the TRSL officials, TRSL does have an unwritten policy of not hiring any consultant who accepts soft dollars from investment managers. In TRSL's two most recent consultant contracts, there are provisions regarding disclosure of conflicts of interest, independence, and ethics compliance. However, TRSL does not have written policies regarding disclosure of potential conflicts of interest by its consultant.

**Recommendation 19:** TRSL should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest between consultants and current and prospective investment managers and custodians.

**Management's Response:** We disagree that the recommendation is needed, since disclosure requirements of actual and potential conflicts of interest are presently included in investment consultant contracts (see Appendix D for TRSL's full response).

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## SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. We followed the applicable generally accepted government auditing standards as promulgated by the Comptroller General of the United States. Preliminary work on this audit began in April of 2004.

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### Scope

This audit focused on TRSL's investment activities from fiscal year 2002 through December 2004. For certain parts of our investment work, we reviewed documents and information for years prior to fiscal year 2002. We obtained investment return data for different classes of assets and determined if the system had instituted an asset allocation plan in its investment policy. We evaluated whether the TRSL staff, its consultants, and the board monitored compliance with the allocation plan and made adjustment to asset levels when appropriate. We reviewed the fees the system is paying to its contractors and how the fees compare with averages obtained from three surveys. We examined how TRSL and its board of trustees selected and monitored investment managers, their consultants, and custodian. In addition, we examined how the system and its board took corrective action for any poorly performing contractor.

This audit also focused on certain ethics-related activities for the time period from July 1, 2003, through October 15, 2004. We examined relationships among the TRSL's board and key employees and the investment consultants, managers, and custodian of this system. We also reviewed the steps that the system takes to ensure compliance with the state's ethics laws.

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### Methodology

We performed several tasks, which include the following:

- Conducted background research, including reviewing laws and information concerning the four state retirement systems
- Held an entrance conference with TRSL on August 3, 2004
- Obtained investment return information from TRSL's investment consultant
- Reviewed TRSL's asset allocation study prepared by its consultant
- Obtained two surveys of pension plans that provided data on fees
- Determined the fees TRSL currently pays by reviewing the contracts and invoices for money managers, the consultants, and the custodian



- Compared the survey fee estimate data to the fees paid by TRSL
- Gathered criteria from the GFOA, the Association for Investment Management and Research (AIMR), and state laws on selecting, monitoring, and taking corrective action for money managers, consultants, and custodian
- Met with TRSL's management to discuss criteria and interviewed TRSL's management and reviewed TRSL's policies to determine how investment professionals are selected and monitored and how corrective action is taken for a poorly performing contractor
- Attended meetings of the system's investment committee and board of trustees and reviewed minutes of meetings of the committee and board
- Obtained a listing of all alternative investment assets owned by TRSL and the Louisiana State Employees' Retirement System to determine if the same asset was held by more than one alternative investment manager
- Reviewed state ethics law and all of TRSL's written policies for ethics work
- Developed criteria using the GFOA, the AIMR, and state laws
- Drafted and sent representation letters to TRSL staff, trustees, money managers, consultants, and custodian asking them to list things of value given or received to one another and disclose relationships that could be a conflict of interest, such as those involving family members, business associates, ownership interests, financial interests, et cetera



## COMPARABLE BENCHMARK INDICES

TRSL Asset Classes and Comparable Benchmark Indices	
Asset Class	Comparable Benchmark Index
Domestic Large Cap Growth Equity	<b>Russell 1000 Growth Index</b> - measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Index measures the performance of the 1,000 largest U.S. companies.
Domestic Large Cap Value Equity	<b>Russell 1000 Value Index</b> - measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.
Domestic Mid-Cap Growth Equity	<b>Russell Midcap Growth Index</b> - measures the performance of those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index.
Domestic Mid-Cap Value Equity	<b>Russell Midcap Value Index</b> - measures the performance of those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.
Domestic Small Cap Growth Equity	<b>Russell 2000 Growth Index</b> - measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Index measures the performance of the smallest 2,000 U.S. companies in the Russell 3000 Index. The Russell 3000 Index contains the largest 3,000 U.S. companies.
Domestic Small Cap Value Equity	<b>Russell 2000 Value Index</b> - measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.
International Equity	<b>MSCI EAFE (Morgan Stanley Capital International - Europe, Australia, Far East) Net Dividend Index</b> - measures the performance of 21 developed market country equity indices, excluding the U.S. and Canada. The Net Dividend Index is a variant of this index that approximates the minimum possible dividend reinvestment. The dividend is reinvested after deduction of withholding tax, applying the rate to non-resident individuals who do not benefit from double taxation treaties. MSCI uses withholding tax rates applicable to Luxembourg holding companies, as Luxembourg applies the highest rates.

(Continued)

TRSL Asset Classes and Comparable Benchmark Indices	
Asset Class	Comparable Benchmark Index
Domestic Inv Grade Fixed	<b>LB Aggregate Bond Index</b> - market capitalization weighted index of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of at least one year.
High Yield Fixed Income	<b>ML High Yield Master II</b> - an unmanaged market value-weighted index of all domestic and Yankee high yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3 but are not in default.
Global Fixed Income	<b>Citigroup World Government Bond</b> - includes the 18 government bond markets. Market eligibility is determined based on market capitalization and investibility criteria. A market's eligible issue must total at least U.S. \$20 billion, for three consecutive months for the market to be considered eligible for inclusion.
Domestic Private Equity, International Private Equity, Real Estate, and Mezzanine Debt	<b>S&amp;P 500 Index Plus 4%</b> - Standard & Poor's 500. A basket of 500 stocks that are considered to be widely held. The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole. TRSL added 4% to the S&P 500 rate of return for its benchmark.
<b>Source:</b> Prepared by legislative auditor's staff from data provided by TRSL, <a href="http://www.russell.com">www.russell.com</a> , <a href="http://www.msci.com">www.msci.com</a> , <a href="http://www.alaskatrust.com">www.alaskatrust.com</a> , <a href="http://www.investorwords.com">www.investorwords.com</a> , and the Louisiana State Employees' Retirement System.	

(Concluded)

## MEALS PROVIDED TO TRSL'S TRUSTEES, KEY STAFF, AND CONSULTANT

Provider	Recipient	Gift	Value	Date
Apollo Management	TRSL trustees	meeting, lunch, activities	Unknown	2003
Apollo Management	TRSL trustees	meeting, lunch	Unknown	2004
Holbein Associates	Jerry Baudin (trustee)	meal	\$71.33	7/6/2003
Cohosted by FLA Asset Mgt., Senca Capital	TRSL trustees, Holbein (consultant)	meal	Unknown	7/7/2003
Atlanta Capital	Dan Bryant (staff)	lunch	\$94.80	7/7/2003
Mellon	TRSL staff	lunch	\$157.00	7/15/2003
Goldman Sachs	Eula Beckwith and spouse (trustee and guest)	dinner & drinks	\$326.46	7/16/2003
Rothschild	Scott Coopridier of Holbein (consultants)	dinner	\$165.27	7/23/2003
Boston Global Adviser	Dan Bryant, Paula Bezard (staff), Jerry Baudin (trustee)	meal	\$590.92	7/24/2003
Holbein Associates	Senator Lambert Boissiere (trustee)	meal	\$85.10	7/29/2003
Artisan	Dan Bryant (staff), Sheryl Abshire (trustee), and other trustees	dinner	\$597.14	7/30/2003
Holbein Associates	Brendan Brosnan (staff)	meal	\$89.36	7/30/2003
Cohosted by Artisan, TT International, and New Star International	Holbein consultants and TRSL trustees	dinner	Artisan \$753.59 New Star International \$753.06 TT International \$752.46	7/31/2003
Atlanta Capital	Bonita Brown (staff)	meal	Unknown	8/5/2003
Mellon	Holbein consultants	lunch	\$38.00	8/6/2003
Systematic	Dan Bryant (staff)	lunch	\$117.83	8/7/2003

(Continued)

# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

Provider	Recipient	Gift	Value	Date
Brinson Partners	Dan Bryant (staff)	meal	Unknown	8/19/2003
Westbrook	Dan Bryant (staff)	meal	Unknown	8/27/2003
Julius Baer	TRSL trustees, consultant, others	dinner	Unknown	9/1/2003
Holbein Associates	Sheryl Abshire (trustee)	meal	\$32.13	9/3/2003
Cohosted by Brandywine and Trust Company of the West	TRSL trustees	dinner	Brandywine \$1,980.18 TCW \$1,639.91	9/4/2003
Deutsche European Partners	Dan Bryant (staff)	dinner	\$60.00	9/9/2003
TT International	Dan Bryant (staff)	dinner	\$518.34	9/10/2003
Deutsche Asset	Dr. and Mrs. Baker (trustees)	lunch	\$57.85	9/10/2003
Seix Advisors	Scott Coopridger, Matt O'Reilly (consultants)	meal	\$40.00	9/11/2003
Maxcor (Eurobrokers)	TRSL trustees and staff	meal	\$2,191.46	9/16/2003
Westbrook	Jerry Baudin (trustee)	meal	Unknown	9/27/2003
Banc One	TRSL trustees	meal	\$429.00	10/1/2003
Fountain Capital	TRSL trustees and staff	meal	\$1,443.58	10/6/2003
UBS Global	TRSL trustees and staff	meal	Unknown	10/11/2003
Trust Company of the West	TRSL trustees and staff	dinner	\$1,900.21	10/12/2003
Cohosted by Brandywine & Rothschild	TRSL trustees and staff	dinner	Brandywine \$761.31 Rothschild \$767.31	10/14/2003
Brandywine	TRSL trustees	transportation to dinner**	\$178.75	10/14/2003
Deutsche Asset	TRSL trustees and staff and non-TRSL guests	dinner	Unknown	10/15/2003
Deutsche Asset	Dr. Bill Baker (trustee)	lunch	\$17.50	10/15/2003

(Continued)

Provider	Recipient	Gift	Value	Date
Audax Mezzanine Fund	Dan Bryant (staff)	dinner	\$100.00	10/22/2003
Mellon	TRSL staff	dinner	\$722.00	10/28/2003
Deutsche Asset	Dan Bryant (staff) and Non-TRSL guests	dinner	Unknown	10/29/2003
Banc One	TRSL trustees	meal	\$872.16	11/3/2003
The Blackstone Group	Dan Bryant (staff)	lunch	\$70.00	11/3/2003
Atlanta Capital	Dan Bryant (staff), Jerry Baudin (trustee)	dinner	\$513.96	11/4/2003
Peregrine	TRSL trustees and staff	dinner	\$872.16	11/4/2003
Brandywine	Dan Bryant (staff)	meal	Unknown	11/25/2003
Atlanta Capital	Dan Bryant (staff), Bill & Anne Baker (trustees)	dinner	\$396.26	12/6/2003
Rothschild	Holbein (consultants)	Drinks	\$126.53	12/8/2003
Cohosted by: 48 Managers	Trustees, consultants, and others	dinner	\$2,550*	12/8/2003
Goldman Sachs	Dan Bryant (staff)	drinks	\$29.00	12/8/2003
Hicks, Muse, Tate & Furst	TRSL trustees and guests	cocktail reception	\$3,632.85	12/9/2003
Deutsche Asset	Dan Bryant (staff)	lunch	\$144.81	1/7/2004
Cohosted by Artisan, TT International, and New Star International	TRSL trustees	dinner	Artisan \$984.63 TT \$984.63 New Star \$984.64	1/8/2004
Mellon	TRSL staff	lunch	\$74.00	1/26/2004
Artisan	Sheryl Abshire and daughter (trustee)	dinner	\$314.72	1/29/2004
Warburg Pincus	Dan Bryant (staff)	meal	Unknown	1/29/2004
Cohosted by FLA Asset Mgt., Senca Capital	Holbein Associates and TRSL trustees	meal	Unknown	2/2/2004

(Continued)

# TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

Provider	Recipient	Gift	Value	Date
Westam	Bonita Brown, Dan Bryant (staff)	lunch	\$147.24	2/3/2004
Hamilton Lane Advisors	Dan Bryant, Bonita Brown (staff), Jerry Baudin (trustee)	meal	\$260.79	2/4/2004
Goldman Sachs	Dan Bryant (staff)	lunch	\$112.20	2/11/2004
Atlanta Capital	Dan Bryant (staff), Jerry Baudin (trustee)	dinner	\$475.78	2/18/2004
Holbein Associates	Anne Baker, William Baker, Sally Cox (trustees)	meal	\$68.94	2/29/2004
Cohosted by Rhumbline & Trust Company of the West	TRSL trustees and consultant	dinner	Rhumbline \$688.68 TCW \$752.70	3/1/2004
Mellon	TRSL staff	lunch	\$89.00	3/10/2004
Mellon	TRSL staff	meal	\$25.00	3/11/2004
Nicholas-Applegate	TRSL trustees and staff	dinner	\$612.45	3/18/2004
Credit Suisse First Boston	Jerry Baudin (trustee), Bonita Brown, Dan Bryant (staff)	meal	\$120.00	3/25/2004
Deutsche Asset	TRSL trustees and Non-TRSL guests	lunch	Unknown	4/1/2004
Cohosted by Rothschild & Systematic	TRSL trustees and staff	dinner	Rothschild \$694.40 Systematic \$700	4/5/2004
Rothschild	Scott Coopridier, Richard Holbein (consultant)	drinks & snacks	\$47.31	4/5/2004
EBS	Bonita Brown (staff)	meal	Unknown	4/24/2004
UBS	Sheryl Abshire and spouse (trustee)	dinner	\$439.60	5/1/2004
Ariel Capital	Sheryl Abshire (trustee)	dinner	\$253.08	5/2/2004
Deutsche Asset	TRSL and Non-TRSL guests	dinner	Unknown	5/3/2004

(Continued)

Provider	Recipient	Gift	Value	Date
UBS	Dan Bryant (staff), Eula Beckwith (trustee)	lunch	\$199.87	5/3/2004
Atlanta Capital	Dan Bryant (staff)	dinner	\$338.66	5/4/2004
Deutsche Asset	TRSL and Non-TRSL guests	dinner	Unknown	5/4/2004
Wellington	Eula Beckwith (trustee)	meal	Unknown	5/4/2004
ING Realty Partners	Sheryl Abshire (trustee)	meal	\$138.50	5/4/2004
Cohosted by Furman Selz & ING	Eula Beckwith (trustee)	meal	Unknown	5/5/2004
Cohosted by Deutsche Asset, UBS, & LSV	TRSL and Non- TRSL guests	dinner	Deutsche \$unknown UBS \$892.00 LSV \$835.40	5/10/2004
LSV	Rich Holbein, Scott Coopridger (consultants)	drinks	\$44.00	5/10/2004
Peregrine	Dan Bryant (staff)	dinner	\$131.00	5/12/2004
Julius Baer	TRSL trustees, consultant, others	dinner	\$463.01	6/1/2004
Holbein Associates	Anne Baker, William Baker (trustees)	meal	\$41.20	6/6/2004
Cohosted by Hamilton Lane Advisors and Mellon	TRSL trustees	meal	Mellon \$1,167.00 Hamilton Lane \$1,167.78	6/7/2004
Boston Global Adviser	Paula Bezard and spouse, Dan Bryant (staff)	dinner	\$500.00	6/23/2004
Doughty Hanson & Co.	Sheryl Abshire (trustee)	dinner	\$50.00	7/3/2004
Deutsche Asset	Dan Bryant (staff)	lunch	\$141.63	7/7/2004
Cohosted by Ariel Capital & EBS	TRSL trustees	dinner	Ariel \$463.01 EBS \$463.02	7/8/2004

(Continued)

## TEACHERS' RETIREMENT SYSTEM OF LOUISIANA

Provider	Recipient	Gift	Value	Date
Cohosted by Atlanta Capital, Goldman Sachs, & Smith Asset	Holbein Associates (consultant) and TRSL trustees and staff	dinner	Atlanta \$1,632.16 Goldman Sachs \$1,422.31 Smith \$1,422.33	8/2/2004
UBS	Matt O'Reilly, Scott Coopridier (consultant)	lunch	\$285.00	8/4/2004
Seix Advisors	Dan Bryant (staff)	meal	\$50.00	8/17/2004
Westam	Dan Bryant, Bonita Brown (staff)	lunch	\$139.63	8/18/2004
Peregrine	Scott Coopridier (consultant)	meal	\$37.42	8/31/2004
Trust Company of the West	Dan Bryant (staff), Jerry Baudin, Anne and William Baker (trustees)	dinner	\$440.98	9/1/2004
Cohosted by Brandywine & Trust Company of the West	TRSL trustees and staff	dinner	Brandywine \$930.54 TCW \$855.14	9/2/2004
LSV	Dan Bryant (staff) and Jerry Baudin (trustee)	drinks	\$85.00	9/9/2004
New Star International	Dan Bryant (staff)	meal	\$96.33	9/9/2004
Shenkman Capital	Holbein consultants, TRSL trustees and staff	dinner	\$725.57	10/7/2004
Goldman Sachs	TRSL trustees and staff	dinner	\$970.00	10/9/2004
<b>Total</b>			<b>\$51,597.86</b>	
<p>*Most of the bill can be attributed to the managers, as there were 110 of them attending, with only 14 of the trustees/staff acknowledging that they attended. Therefore, we divided 124 in to the total cost (\$22,586) of the meal resulting in a cost of approximately \$182 per person. We then multiplied \$182 by 14 and got \$2,550. This is the total we used in this table.</p> <p>**Included in this chart because incidental to dinner.</p> <p><b>Source:</b> Prepared by legislative auditor's staff using information provided by TRSL's key staff, board of trustees, investment managers, consultant, and custodian.</p>				

(Concluded)



**MANAGEMENT'S RESPONSE**





Teachers' Retirement System of Louisiana

www.trsl.org

225.925.6446

Post Office Box 94123

Baton Rouge LA 70804-9123

**Board of Trustees**

Sheryl R. Abshire  
Chair  
7th District

Sally F. Cox  
Vice Chair  
4th District

Lawrence J. Moody, Jr.  
1st District

Eula M. Beckwith  
2nd District

Clyde F. Hamner  
3rd District

Irvin R. West, Jr.  
5th District

Joyce P. Haynes  
6th District

Anne H. Baker  
Retired Teachers

William C. "Bill" Baker, Ed.D.  
Retired Teachers

Jerry J. Baudin, Ph.D.  
Colleges & Universities

Charles P. Bujol  
Superintendents

Syble T. Jones  
School Food Service

**Ex Officio**

Lambert Boissiere, Jr.  
Chairman, Senate  
Retirement Committee

John N. Kennedy  
State Treasurer

Cecil J. Picard  
State Superintendent  
of Education

Pete Schneider  
Chairman, House  
Retirement Committee

**Director**

Bonita B. Brown, CPA

**Assistant Directors**

Graig A. Luscombe  
Dana L. Vicknair

**Chief Investment Officer**

Dan H. Bryant

**General Counsel**

William T. Reeves, Jr.

**Executive Assistant**

Liz Guidry-Saizan

April 6, 2005

Mr. Steve J. Theriot, CPA  
Legislative Auditor  
1600 North Third Street  
Post Office Box 94397  
Baton Rouge, LA 70804-9397

Dear Mr. Theriot:

This letter is in response to your April 2005 performance audit report concerning the investment operations at TRSL.

Your report states that TRSL's investment performance exceeds benchmark (index) returns, since inception, by approximately \$425 million. Without these excess earnings, the State of Louisiana would have had to provide this money through increased employer contributions. We were able to lower the state's cost and, at the same time, keep our own expenses to the minimum required to provide TRSL members an excellent level of service. The report confirms that TRSL, on balance, is performing extremely well.

Despite our disagreement with some of the conclusions in the report, we believe that this has been a very worthwhile learning experience for TRSL staff. Your audit staff has offered some helpful suggestions that we will incorporate into TRSL operations to further strengthen an already solid program. Please thank your staff for their professionalism and for their fair presentation of the report. They did an excellent job with a very complex and difficult assignment.

The attached pages contain our responses to each recommendation in the report.

Sincerely,

Bonita B. Brown, CPA  
Director

BBB/ASC

Attachment



# TRSL Teachers' Retirement System of Louisiana

## Management's Response

Louisiana Legislative Auditor  
Performance Audit Report - Investments - Issued April 2005

Recommendation 1: TRSL should ensure that when asset manager investment returns are compared to benchmarks in investment performance reports, they are presented net of investment management fees or with the information necessary to accurately adjust these rates to show returns net of fees.

*We agree that showing returns net of fees for all investment managers is a useful tool, and we will begin including such in TRSL's monthly reports to the Board of Trustees.*

Recommendation 2: TRSL should work to develop appropriate benchmarks for each of its alternative investment asset classes so that their long-term performance can be objectively evaluated.

*We agree that there may exist more appropriate benchmarks for alternative investment subclasses and will work with our alternative investment consultant to explore this possibility.*

Recommendation 3: TRSL's written investment policy should ensure that the use of index funds as an alternative to active management is "formally and regularly" evaluated.

*We partially agree with the recommendation, in that TRSL already evaluates the use of index funds regularly. Since TRSL evaluates the use of all classes of investments through regular asset allocation studies, we do not believe that singling out, in policy, the review of index funds is warranted. As noted in your report, TRSL has earned hundreds of millions of dollars in excess returns by choosing and managing active investment managers. Due to the requirement that TRSL earn an 8.25% annual return on investments, index returns, which would not allow TRSL to reach the 8.25%, would be an inappropriate vehicle for the bulk of TRSL's assets. However, we will continue to use index funds as required by law and as appropriate short-term investment vehicles.*

Recommendation 4: TRSL should develop and implement specific written policies concerning rebalancing. These policies should state who will be responsible for rebalancing, and provide guidelines for how and when rebalancing will be carried out.

*We partially agree with the recommendation. TRSL will implement a section on rebalancing in the investment policy. However, we will not include specific rebalancing timeframes or requirements, since each rebalancing decision will be based on multiple, complex factors such as market conditions, future planned or possible reallocations, future expected private partnership cash flows, etc. We would like to point out that TRSL's previous rebalancing decisions have been sound, and they have resulted in saving or increasing assets by hundreds of millions of dollars.*

Recommendation 5: If the amounts in asset classes are still outside of their target ranges, TRSL should take immediate steps to rebalance its portfolio so that it is in compliance with its asset allocation policy or change the target ranges in its policy. TRSL should consider the illiquidity of the alternative investment asset classes when setting target ranges. These asset classes may need wider ranges within which to operate than the more liquid asset classes.

*We agree, since we have already planned to rebalance due to the asset allocation study that we are presently performing, as previously communicated to your audit staff.*

Recommendation 6: TRSL staff should better organize and keep all documents related to its due diligence activities during search/selection processes.

*We partially agree, in that we believe that TRSL maintains adequate due diligence documentation to support all decisions. However, we continuously strive to improve TRSL operations in all respects and will better document due diligence activities in the future.*

Recommendation 7: TRSL should adopt written, general descriptions of duties and responsibilities for its custodian and each of its three consultants. These duties and responsibilities should be placed in the board's policies.

*We agree with the recommendation.*

Recommendation 8: TRSL should include a prohibition against using affiliated brokers in its investment manager contracts and review trading activity once a manager is hired to ensure that affiliated brokers are not used.

*We partially agree, in that trading with affiliated brokers should be prohibited in most cases. However, with regard to international investment managers, best execution can sometimes be significantly harmed by such prohibitions since an affiliated, very large broker may be the best entity to execute a difficult trade. We will continue to use a global transaction measurement service to monitor all managers' trading for best execution.*

Recommendation 9: TRSL should formalize its current practices for monitoring investment managers for the churning of TRSL assets into its written policies.

*We disagree, since TRSL presently addresses in the investment policy the monthly review of investment managers. The review of investment managers includes a review of their trading results, as deemed necessary, using the global transaction measurement service to which TRSL subscribes.*

Recommendation 10: TRSL should formalize its current practices for evaluating its consultants into its written policies.

*We partially agree. We agree that an annual review of the consultant is needed, which we presently perform. However, we disagree that this recommendation is needed, since the Board of Trustees, by formal resolution, requires the annual evaluation of all investment consultants.*

Recommendation 11: TRSL should develop and implement written policies and procedures for formal custodial reviews (at least annually). These policies and procedures should state the frequency of evaluations and the areas to be evaluated.

*We partially agree with the recommendation, since TRSL, although not formally, already monitors the custodian and takes corrective action as needed. TRSL has replaced its custodian twice in the past ten years for performance reasons. TRSL will formally review the custodian annually and will require such by Board resolution or in policy.*

Recommendation 12: TRSL should formalize its current practices related to corrective action against investment managers into its written policies.

*We partially agree, in that written policies may help someone outside of TRSL to understand the process. We will include general statements in policy concerning corrective actions against investment managers. However, evaluating the performance of and taking corrective action with regard to investment managers will continue to be done on a case-by-case basis, since no simple*

*set of rules in a policy can address very complex and unique situations. For example, a high-yield bond manager hired to invest in higher-grade, high yield bonds may underperform the benchmark when the lowest grade bonds in the market outperform. Terminating that manager or placing them on a watchlist would be punishing them for doing what we hired them to do. It could also be counterproductive, since the market could turn around and favor that manager.*

Recommendation 13: TRSL should obtain an opinion from the Louisiana Board of Ethics concerning whether acceptance of the gift, travel reimbursements, and charitable donations constitute a violation of the Louisiana Code of Governmental Ethics. If the Louisiana Board of Ethics' opinion states that these are violations, TRSL should strengthen policies and procedures to ensure that all staff and trustees adhere to the Louisiana Code of Governmental Ethics. TRSL should clearly communicate the applicability of the ethics code to TRSL's trustees and staff and the provisions of the code to all investment managers.

*TRSL's general counsel disagrees that any items listed are gifts in violation of ethics law. TRSL staff will consult with the Board of Trustees on the necessity of obtaining an opinion from the Board of Ethics. The applicability of the ethics code has been, and continues to be, communicated clearly to all associated with TRSL. Specifically with regard to each item mentioned in the report:*

- The item listed as "Christmas Baskets from Harry and David's" was indeed delivered to TRSL in December 2003, despite the vendor being previously warned, in writing, not to send such gifts. Because TRSL's policy prohibits such gifts, we immediately donated the item to a March of Dimes benefit and reminded the vendor of ethics law prohibitions of gifts. TRSL paying shipping to send a perishable good back to the vendor would have been fiduciarily irresponsible.*
- Charitable contributions are not gifts, based upon the Louisiana Code of Governmental Ethics (Code). According to the Code, "no public servant shall accept any thing of economic value" (gift). With the two cases of an outside firm donating to charity in TRSL's honor, there was nothing of economic value accepted by anyone associated with TRSL, so there was no gift. TRSL and no one associated with TRSL receives a benefit, direct or indirect, when someone we have no control over makes an unsolicited donation to the charity of their choice, for which the donating firm can claim a tax deduction. For example, if such were considered a gift, then any vendor of the Legislative Auditor's office could put the Legislative Auditor in violation of ethics law simply by donating to charity in the Legislative Auditor's honor.*
- The hotel/airfare items listed are contractually required expenses of the private partnerships in which TRSL invests, expenses that TRSL pays indirectly through management fees. These due diligence trips are required by the partnerships and by fiduciary duty for annual partnership advisory committee meetings to approve investment valuations, evaluate conflicts of interest, etc. These expenses cannot be negotiated out of the management fees that TRSL pays since all limited partners are required to pay the same fee. If TRSL paid the expenses of these due diligence trips, TRSL would be paying such expenses twice, which is not a fiduciarily prudent action and could be considered an unconstitutional donation of TRSL funds to the private partnership.*

*A good analogy is TRSL's partnership with LASERS in the ownership of the building in which both systems operate. The partnership pays the electricity payment each*

*month, which is not considered a gift to TRSL but a legitimate business expense. Similarly, an investment partnership in which TRSL is a partner pays the travel expenses of each partner to the annual partnership advisory committee meetings, which is not a gift to TRSL but a legitimate business expense.*

Recommendation 14: TRSL should strengthen policies and procedures to ensure that all trustees and staff avoid conflicts of interest and the appearance of conflicts of interest with current and prospective investment managers.

*We disagree. TRSL already has in place policies and procedures more strict than the law requires, and these policies and procedures have been effective in preventing conflicts of interest.*

Recommendation 15: TRSL should set policies regarding the frequency and dollar value of meals accepted by staff, trustees, and consultants from investment managers, custodians, and consultants.

*We disagree. TRSL already has in place policies requiring staff, trustees, and consultants to follow ethics laws with regard to meals. For the record, at least 50 percent of the dollar value of meals reported by investment managers and consultants is for themselves and for their guests, not for TRSL trustees and staff.*

*The report states that a conflict of interest may exist when an investment manager buys a meal for a TRSL official. However, your report shows the opposite. Your report acknowledges that TRSL objectively hires top performers, objectively and actively monitors their performance against predetermined benchmarks, and objectively fires poor performers when required. Not one connection was made, or exists, that an occasional meal has affected that performance-based, objective investment management process. TRSL fires an average of five underperforming investment managers per year, and has done similarly for the past decade. Indeed, three managers that are listed in your report as having provided meals to TRSL trustees have already been replaced. In short, evidence in your own report refutes the notion that a TRSL official accepting a meal has created a conflict of interest. Your report should read: "Evidence exists that TRSL officials accepting meals from investment managers does not affect their judgment."*

*The elected trustees of TRSL are unpaid volunteers who donate their time and talent in guiding TRSL for the sole benefit of its membership. Having their integrity called into question because of accepting an occasional meal, when your report proves that their decisions are based on sound, objective factors, is disappointing. Be assured that TRSL will continue to follow the letter and the spirit of the ethics laws regarding meals, as conclusions in your report show that we have done.*

Recommendation 16: TRSL should strengthen their blackout period procedures to prohibit all contact between potential contractors and the trustees outside of board and committee meetings during the entire selection process regardless of prior relationships between the system and the contractors in question.

*We agree with the recommendation.*

Recommendation 17: TRSL should add its blackout period provisions to the TRSL Board Governance policies to ensure that no violations occur and make all relevant parties aware of the policy.

*We agree with the recommendation.*

Recommendation 18: TRSL should develop and implement written policies to ensure that investment managers disclose and avoid any potential conflicts of interest.

*We partially agree with the recommendation. Although TRSL presently requires disclosure of conflicts of interest in the hiring process, we will develop conflict of interest provisions to be included in future investment manager contracts.*

Recommendation 19: TRSL should develop and implement policies and procedures for the disclosure and treatment of conflicts of interest and the appearance of conflicts of interest between consultants and current and prospective investment managers and custodians.

*We disagree that the recommendation is needed, since disclosure requirements of actual and potential conflicts of interest are presently included in investment consultant contracts.*